

### Rethinking EU-Russia energy relations: what do the Baltic States want?

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# SPES Policy Papers

## Rethinking EU-Russia energy relations: What do the Baltic States want?

*Arunas Molis*

February 2011

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## Introduction

Dependency and the absence of a well functioning energy market are the most challenging relics of the Soviet legacy in the Baltic States. In the electricity sector, Lithuania's, Latvia's and Estonia's grids are all linked to the post-Soviet, Eastern system. In the gas sector, all three countries have no option other than to import gas exclusively from Gazprom. Major vulnerability is caused by a specific circumstance in this regard: the single supplier, or regulator in the case of electricity, tends to follow a strategy of 'energy diplomacy', rather than the principles of a market economy. The obligation to pay a considerably higher price for natural gas than many other member states of the European Union (EU), the avoidance of the Baltic States as transit countries, and blackmail regarding possible supply disruptions are clear consequences of this situation.

The governments of the Baltic States<sup>1</sup> claim that the close connections between the Kremlin's foreign policy and the 'selective' supply and pricing strategies of Gazprom create a dependence on supplies from Russia that jeopardises their national security (Spruds 2009). A centralised gas sector in Russia and the attitude of the highest Russian officials towards energy affairs indicate that the politicisation of energy affairs will not cease in the foreseeable future. In other words, if nothing is done, the threat of increasing energy prices, supply disruptions and blackmail will continue, at least under the current Russian government. This will further challenge the political independence of the Baltic States.

In light of these concerns, the Baltic States are looking for possibilities to change the situation. Some aspects of the Baltic States' energy security may be covered by national measures. Other threats can be addressed by developing regional cooperation and implementing joint energy

infrastructure projects. However, this paper presumes that without the contribution of the EU, the Baltic States will not escape their 'energy island' status for years. Their negotiating power and financial capacities are simply too weak for negotiations with partners such as the Russian government and Russian companies such as Gazprom, the United Energy System (UES) of Russia or Transneft. It may be assumed that the Baltic States have a genuine interest in a stronger EU energy policy and support ideas such as the creation of a European Energy Community (Andoura et al. 2010). To have a meaningful impact on the EU-Russia energy cooperation structure and content is among the most important aspects in this regard.<sup>2</sup>

In seeking EU support in energy affairs, the Baltic States face a twofold problem. First, supranational EU involvement in energy affairs is a quite recent phenomenon. Therefore it has to be constantly promoted, developed, and improved. Second, the EU member states are significantly divided over how to deal with energy risks, what should be the priorities of the EU internal and external energy policy dimensions. For instance, countries, which are interested in participating in Russian oil and gas production and export projects<sup>3</sup> develop and sustain bilateral energy relations with Moscow, even if this means deviating from a position of solidarity with other EU member states. Those, which heavily depend on Russian imports, favour a tougher stance towards Russian energy policy. They ask for deeper integration of the European energy market and the development of an external EU energy policy, but face the challenge of persuading sceptics of the need for this. Assuming the high importance of a coordinated and institutionalised EU external energy policy for the Baltic States, this paper focuses on their motives and strategies

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1 As energy security is crucial for the national security of the state, the governments of the Baltic States pay great attention to the development of this sector. Thus, in this paper the terms 'Baltic States' interests', 'Baltic States' concerns' etc. mean the interests, concerns, and positions of the state (i.e. the interests or official positions of the Baltic States' governments).

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2 The current institutional structure of the EU-Russian Energy Dialogue is presented in Figure 1 (see annexe).

3 Examples of such investments include those made by Germany's Ruhrgas towards the modernisation of Gazprom's gas-export infrastructure, the Gazprom and French Total agreement to jointly design, finance, construct and operate the Shtokman gas field. The joint venture South Stream AG, equally owned by Gazprom and Italian Eni and created to execute the South Stream pipeline project, can be also mentioned in this regard.

in shaping the EU's strategic position towards the main energy supplier, Russia.

Many European and Baltic researchers focus their recent analyses on EU energy policy, EU-Russia energy relations, or the energy security interests of the Baltic States in general. However, none of them has ever tried to unite these aspects and provide a deeper analysis of the Baltic States' approach towards the most important aspect of the external dimension of the common EU energy policy: EU-Russia energy cooperation. This study, concentrating on current events and the latest tendencies, at least partially attempts to compensate this gap. First of all, it aims to explain the paradoxical situation, whereby Lithuania, Latvia and Estonia, whose dependence on Gazprom gas is striking, all advocate for measures, which are in fact impeding the development of closer EU-Russia energy ties. In discussing the Baltic States' expectations in relation to EU-Russia energy cooperation, this study explains major historical, political and economic reasons for such a 'hostile' approach towards Russia and its energy companies, and presents ways in which the Baltic States hope to safeguard their energy security. The second aim of this study is to provide an overview of the alternative energy supply infrastructure development projects, which could mitigate the negative consequences of the Baltic States' dependence, and to analyse the Baltic States' interests in developing the external dimension of the common EU energy policy.

It is presumed that both individually and even jointly the Baltic States are too small for bilateral negotiations with suppliers, of which Russian companies and the Russian government are first and foremost. In other words, at least in the near future, the Baltic States have no choice other than to seek the replacement of bilateral relations with Russia (or Gazprom) with multilateral EU-Russia negotiations regarding supply volumes, prices, investments, etc. Against this background the research question of this paper is: *why and in which direction do the Baltic States want to shape the development of an EU energy policy?* This paper neither proposes a magic formula nor has the ambition to become a handbook for Baltic and EU energy policy decisions shapers and makers.

However, it explains the reasons for the Baltic States' concerns and argues that the absence of a common understanding of the principles of 'solidarity' and 'reciprocity' has a negative impact both on EU energy policy development and the Baltic States' energy security. By assessing the potential of the Baltic States' priorities and contrasting them with the views and positions of Western governments, experts and private firms, this paper argues that without a coherent external EU energy policy dimension – meaning first of all a clearly defined and commonly implemented policy towards Russia – the EU will remain the weaker partner in relations with Moscow and the Baltic States will continue to play the role of an easy target for divide-and-rule policies.

In seeking to explain the Baltic States' arguments, this paper starts with a presentation of their import dependence on Russia and their inability to overcome this dependence with either national or regional efforts (chapter 1). The second part focuses on the development of a common EU energy policy, which is perceived as the main instrument for securing a stable and sufficient supply of energy resources to the Baltic States. The creation of a common EU energy market (first of all in the gas and electricity sectors), as well as an increase in the level of gas supply diversification, will be analysed as instruments, which would limit the dominance of Russian companies (chapter 2). The last chapter seeks to explain the importance of 'consumer solidarity' inside the EU and of the 'reciprocity clause' in EU relations with Gazprom, both of which are considered to be the Baltic States' priorities in EU-Russia energy relations (chapter 3).

# I Challenges and opportunities for the Baltic States' energy sector

This chapter is concerned with the existing problems in the Baltic States' energy sector. It also gives a brief overview and assessment of the main projects, which have been implemented so far to diminish the energy insecurities of the region. It will be shown that without political and financial support from the EU, the Baltic States will not be able to achieve their key objectives.

## Overview of the major risks and vulnerabilities

Until the end of 2009, the three Baltic States had quite a diverse energy mix. In Estonia, the energy mix was dominated by the use of oil shale, in Latvia by the use of hydro resources and in Lithuania by the use of nuclear energy. In addition, all three states complemented these energy sources with biofuel, wind energy and, of course, with imports of natural

gas and oil products (Rudzikas 2006). Despite the significant import dependencies in both the oil and gas sectors, the Baltic States can not be treated as purely energy importing and consuming countries. The presence of an oil refinery in Mazeikiai, import/export terminals for oil and oil products in Butinge and Klaipeda (Lithuania), Ventspils, Riga and Liepaja (Latvia), and Tallinn and Sillamae (Estonia), as well as a gas transit pipeline through Lithuania to Kaliningrad, mitigate at least some of the import dependency related risks.

However, in 2002 the Lithuanian government and the European Commission (EC) reached an agreement regarding the decommissioning of the Ignalina Nuclear Power Plant by the end of 2009. At the time, Ignalina not only provided ~80% of Lithuania's domestic electricity requirements but also exported electricity to the other Baltic States. In addition, over a five year period starting in 2016, Estonia will have to comply with EU emissions regulations on large combustion power plants, meaning that the country will practically

**Table 1. Baseline scenario of the main energy balance indicators**

		LITHUANIA			LATVIA			ESTONIA			EU 27		
		2005	2010	2015	2005	2010	2015	2005	2010	2015	2005	2010	2015
Gross inland consumption (ktoe)	Solids	215	355	346	83	82	76	3255	2634	2835	320065	318268	334149
	Oil	2746	2941	3220	1376	1732	2051	1090	1405	1600	665514	674035	690801
	Natural gas	2476	3663	4418	1358	1594	1909	800	973	896	444804	462439	487045
	Nuclear	2666	0	0	0	0	0	0	0	0	257360	245217	243715
	Electricity	-255	24	-71	185	172	181	-138	-151	-102	973	1496	1466
	Renewable	758	843	1015	1718	1910	2127	621	697	670	122689	152646	170461
	Total	8606	7826	8929	4720	5490	6344	5627	5559	5899	1811406	1854101	1927639
As % in gross inland consumption	Solids	2.5	4.5	3.9	1.8	1.5	1.2	57.8	47.4	48.1	17.7	17.2	17.3
	Oil	31.9	37.6	36.1	29.2	31.5	32.3	19.4	25.3	27.1	36.7	36.4	35.8
	Natural gas	28.8	46.8	49.5	28.8	29.0	30.1	14.2	17.5	15.2	24.6	24.9	25.3
	Nuclear	31	0	0	0	0	0	0	0	0	14.2	13.2	12.6
	Renewable	8.8	10.8	11.4	36.4	34.8	33.5	11	12.5	11.4	6.8	8.2	8.8
Net imports (ktoe)	Solids	190	345	339	76	79	72	27	119	129	126702	153315	181784
	Oil	2677	2872	3147	1662	2057	2443	867	1556	1773	589611	623018	669687
	Natural gas	2492	3663	4418	1434	1594	1909	800	973	896	256828	294227	358047
	Electricity	-255	24	-71	185	172	181	-138	-151	-102	973	1496	1466
	Total	5096	6882	7808	2783	3252	3878	1463	2401	2602	975298	1073937	1213468
Import dependency (%)		58.3	86.1	85.6	55.9	55.9	57.6	25.5	42.1	42.9	52.4	56.3	61.2

Source: Capros et al. 2008.



have to cease the production of electricity in oil shale-fired power plants. As a consequence, the Baltic States will have to replace both their nuclear and oil shale energy with imported electricity or gas, which will be required for the generation of electricity. Due to the huge sums of money that will subsequently need to be wired to external energy suppliers, instead of remaining within these countries to support local energy producers, these developments will negatively influence the Baltic States' economies and sharply increase their dependency on energy imports. This latter tendency is clearly illustrated by table 1.

Since gaining political independence, the Baltic States have been dependent on Russia for almost 100% of their gas supplies. A huge share of the internally consumed or refined oil is also imported from either Russia or Belarus, in the case of oil products (Janeliunas, 2009). Additionally, in the electricity sector, the Baltic States have to rely on Russian 'back-up' capacities. Subsequently, analysts from the European Centre for International Political Economy (ECIPE) conclude that the Baltic States are least able to respond to gas supply cuts (see annexe, figure 2). In other words, the analysis of indicators (such as the share of gas in primary energy consumption, the import dependency on Russian gas, the level of retail gas market concentration, the rank of 'effectiveness of antimonopoly policy') has demonstrated that the Baltic States are extremely vulnerable to Gazprom's policies (Dreyer et al. 2010: 1). The main reasons for the Baltic States' energy insecurity may be summarised as follows:

1. **Dependency on a single supplier** (see graph 1): In the gas sector, Gazprom enjoys a so called complete 'vertical monopoly' on the Baltic States' market. As a consequence, the supply of natural gas may be limited or stopped<sup>4</sup> or its price may be lifted at any time without any real negotiations.<sup>5</sup> It is even more dangerous that

the Baltic States' dependence may be used to influence their internal political and economic decisions.<sup>6</sup> Practically, this means that Moscow may use these instruments to create direct political or economic pressure, or as a means of sanctioning.<sup>7</sup> In the electricity sector, the Baltic States are integrated only into the 'UES of Russia' network. This means that in the case of a short term electricity deficit they possess only one option – to rely on a system dominated by Russian electricity providers (Aalto 2008: 9). In the oil sector, dependency risks are also relevant, due to the fact that the Baltic States possess only very limited local oil resources.

2. **Absence of energy interconnections with the energy systems of Northern and Western Europe** (see annexe, figures 3 and 4): Theoretically, energy resources such as gas and electricity could be supplied to the Baltic States from elsewhere, for instance, from the Nordic States. However, usage of these politically 'safe' supplies is practically impossible due to serious infrastructural constraints. In other words, there is physically no gas pipeline uniting the Baltic States with Western or Northern Europe. Integration into

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meters, while Western consumers were purchasing natural gas on the so called 'spot' market for merely \$US 200 for 1000 cubic meters. Besides this, due to the shutdown of the Ignalina Nuclear Power Plant in Lithuania and the problems with oil shale and the transfer to a free electricity market in Estonia, the need for gas in the Baltic States will increase. Due to the lack of alternative resources, which could complement gas as the replacement for nuclear energy and oil shale, Gazprom uses this opportunity to increase the gas price for the Baltic States.

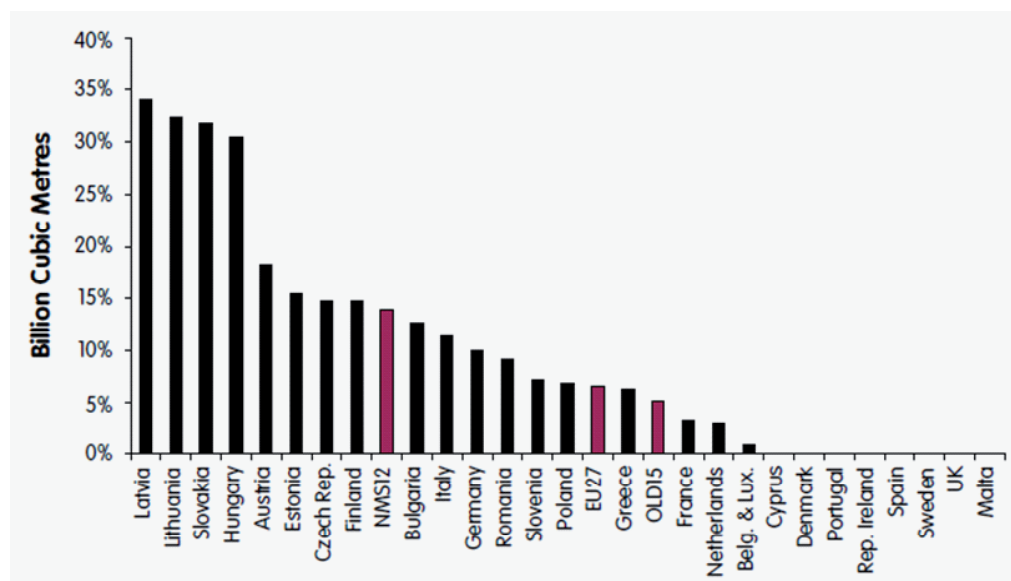
- 6 According to some analysts, dependence on Russian energy supplies is one of the strongest tools Russia currently possesses to influence the policies of Estonia, Latvia and Lithuania. The Baltic States are concerned that Russia may use their energy dependency to interfere in their domestic affairs or force them to make foreign policy concessions (Mae 2009).
- 7 For instance, in January 2003, Russia suspended oil deliveries to the Latvian port of Ventspils. Analysts have noted that this embargo coincided perfectly with Latvia's refusal to sell its oil transit company Ventspils Nafta to the Russian oil company Transneft. Between 1998 and 2000, Transneft cut off oil supplies no less than nine times in order to stop the Lithuanians from selling their port, pipeline and refinery to the American company Williams International (Hamilton 2008). In July 2006, deliveries of crude oil through the Druzhba pipeline to the 'Mažeikiu Nafta' refinery were also stopped after Russia failed to gain control over this energy infrastructure asset (Whist 2008: 23).

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4 Since 1991, Moscow has suspended the gas supply to Eastern European countries for political reasons 40 (!) times (Kolesinskas 2008).

5 Some analysts claim that despite this dependence, consumers in the Baltic States still benefit from gas prices below the EU-27 average. This is, however, not always true. In January 2010, for instance, the gas price in Lithuania was \$US 310 for 1000 cubic

**Graph 1. Russian gas as a share of primary energy supply (2006)**



Source: Noël 2008.

the world's biggest energy grid, Continental Europe (formerly the Union for the Co-ordination of Transmission of Electricity, UCTE), is not yet completed.<sup>8</sup>

3. **Slow growth of renewable energy consumption:** Officially, it is expected that by 2020 the share of renewable energy resources to final energy consumption will be 23% in Lithuania, 25% in Estonia and 42% in Latvia (Europe's energy portal 2009). However, other experts (see table 1) say that these figures are unrealistic and that the use of renewable energy is growing too slowly. The main reasons for this are the high costs of renewable technologies, the lack of stable financial support systems, little technological experience and an unsettled legal base (Piebalgs 2007). In other words, a further increase in renewable resource consumption requires further research and high up-front investments. However, even economically

viable projects face administrative hurdles, as those to be involved with the planning, development, operations or promotion of renewable energy projects lack the required levels of education and training.

4. **Low energy efficiency:** The energy intensity of industry in the Baltic States is one of the highest in the EU. Energy efficiency in buildings, the transport sector and district heating systems are extremely low. This stems from the use of out-dated Soviet technologies, insufficient investment and a weak savings culture. The biggest challenges towards improving the Baltic States' energy efficiency are related to the lack of knowledge and experience in common property management, low incomes and the fear of taking out loans. The inability of residents to agree and make common decisions, the lack of trust and knowledge in the realisation of successful projects and the unattractive financing conditions for energy efficiency investments also play a significant role in this regard (Janeliunas 2009).

<sup>8</sup> As of July 2009, the work of the „Continental Europe“ regional group (formerly UCTE), as well as ATSOI, BALTSO, ETSO, NORDEL and UKTSOA, has been fully integrated into the European Network of Transmission System Operators for Electricity (ENTSO-E). Nevertheless, the principle goal of synchronisation (the integration of Baltic energy grids into the European energy network) remains. For more information on ENTSO-E and „Continental Europe“ energy grid see: <https://www.entsoe.eu/index.php?id=10>, accessed 10 September 2010.

### ***The progress of the Baltic States in the electricity, gas and oil sectors***

It seems that the Baltic States' governments recognise the major risks in the energy sector quite well and are trying to mitigate these vulnerabilities. As far as the electricity sector is concerned, the Baltic States have achieved some limited progress both in planning the construction of a new common Nuclear Power Plant (NPP) to be built in Lithuania and integrating the Lithuanian, Latvian and Estonian electricity systems into the "Continental Europe" regional group. Progress on the development of a common NPP has been registered since the end of 2006, when Lithuanian, Latvian and Estonian energy companies conducted a feasibility study and concluded that the project could go ahead (Spruds 2009). In March 2007, the Lithuanian and Polish Prime Ministers signed a Communiqué, which gave the green light for Poland's participation in the project. In 2009, the Lithuanian government announced a tender to find a strategic investor for a new NPP and parallel negotiations with the two bidders presenting the best offers were planned for 2010.<sup>9</sup> Besides this, in January 2007, the three Baltic States' energy companies completed the 350 MW Estlink project, uniting the Baltic electricity systems with the Finnish one. In January 2009, they succeeded in reaching the EU target of allocating €175 million for the construction of the NordBalt energy link, which will connect the Baltic States with Sweden. All these strategically important projects, which also include the second branch of Estlink and the Lithuanian-Polish energy bridge LitPolLink, have real prospects for being implemented, as in June 2009, eight Baltic Sea member states signed a Memorandum of Understanding on the Baltic Energy Market Interconnection Plan (BEMIP). This plan envisages concrete measures, which have to be taken in order to better integrate the Baltic States' energy systems into the wider EU energy networks (Europa Press Releases 2009).

Besides the construction of the new NPP and

integration into the wider energy grid, there are also other plans on how to improve the provision of electricity in the Baltic States (for details see annexe, chart 1). In this regard, the Baltic States are keen to fully liberalise their markets and to use the potential of the post-Soviet 'UES of Russia' more effectively. As long as the electricity produced by the Ignalina NPP has been the cheapest in the region, there has been no need for the Baltic States to look for import possibilities, but now the situation has changed. Although other domestic power plants (consuming gas, coal and oil products) could potentially produce as much electricity as the countries need, importing electricity from Russia, Ukraine and, in the case of Lithuania, even from the hydro-energy rich Latvia or Estonia (which still fires oil-shale for energy production) is considerably cheaper (Mae 2009). Therefore consumers have become more interested in covering their energy needs through imports and producers are now keen to replace the Ignalina NPP. As a consequence, the idea of having a free electricity market in the Baltic States has gained new momentum. At the beginning of 2010, with the creation of BaltPool, the free market became operational in Lithuania and few months later, in Estonia. Based on the NordPool rules, BaltPool is seen to be the first step on the way to a common electricity market, which is expected to emerge in the Baltic States in the coming years. According to some officials from the Lithuanian Ministry of Energy, even without full integration into the Continental Europe regional group the Baltic States would this way have the possibility of using the NordPool Spot market model for electricity exchange with their Eastern neighbours.<sup>10</sup>

Despite some progress, there are experts who are less optimistic in their assessments of the most ambitious projects of the Baltic States in the electricity sector. For instance, a representative from the Lithuanian Ministry of Energy highlights that the Scandinavian countries themselves currently import electricity from Russia. Therefore expectations that the electricity

9 For more information on NPP and electricity interconnection projects see: [http://www.enmin.lt/en/activity/veiklos\\_kryptys/strateginiai\\_projektai/](http://www.enmin.lt/en/activity/veiklos_kryptys/strateginiai_projektai/), accessed 5 October 2010.

10 Further information on the creation of the "BaltPool" system, which is based on the "NordPool" model, is available at [http://ec.europa.eu/energy/infrastructure/bemip\\_en.htm](http://ec.europa.eu/energy/infrastructure/bemip_en.htm), accessed 5 October 2010.

supply will be diversified through the Estlink or NordBalt interconnections may not be met.<sup>11</sup> An expert from the German Institute of Economic Research underlines that no NPP has ever been built by a private investor in Europe, as the Baltic States plan to proceed. Besides this, the costs and risks associated with nuclear waste storage make the project less attractive to both society and investors, and put the construction process in permanent danger.<sup>12</sup> To summarise, progress in the relatively ‘easy’ electricity sector may take much more time than expected.<sup>13</sup>

The implementation of projects strengthening independence in the gas sector is even more complicated (for details see annexe, chart 1). Governments and private investors are dubious about further investments (in Liquefied Natural Gas (LNG) terminals, gas storages, pipelines), as Gazprom not only supplies 100% of the gas consumed in the Baltic States, but also controls, whether directly or through subsidiaries, both crucial infrastructure objects (pipelines and storage facilities), as well as the gas distribution companies (see annexe, figures 5 and 6 for a graphic representation of the EU’s and Baltic States’ dependence on Russian energy resources).<sup>14</sup> Therefore even if there was a political decision to build an LNG terminal, underground gas storage facilities or a gas interconnection with Poland, Gazprom, together with its partners,

would still have the final word as to whether or not the transportation of this ‘alternative’ gas through the pipelines should be allowed.<sup>15</sup> Taking into consideration Gazprom’s approach towards competition, an agreement with Gazprom or its subsidiaries may be very difficult to reach.

On the other hand, there are also some positive developments in the gas sector. First of all, a large share of Russian oil and oil products is transported to the EU either by tankers via the Baltic ports or pipelines over the Baltic States’ soil. Thus, the fulfilment of Russia’s global energy supply obligations requires considerable cooperation in the Baltic Sea region and prevents Russia from making politically motivated decisions in the energy sector. Second, even the Gazprom subsidiaries in the Baltic States may approve some form of supply route diversification, for instance, the supply of gas to Lithuania, and maybe even Poland, via Latvian territory, since this would allow them to avoid the risks associated with the transit of gas through Belarus.<sup>16</sup> Finally, the governments of the Baltic States have at least theoretical leverage to diminish some of their risks by exploiting the so called ‘Kaliningrad card’.<sup>17</sup> Of course, the pipelines going through Lithuania (see annexe, figure 4) are controlled by companies loyal to Gazprom, which may not agree to satisfy the ‘political’ requirements of the Lithuanian government. The ‘Kaliningrad card’ may also lose its significance if the Nord Stream branch to Kaliningrad is built or a local nuclear power plant is constructed (as the Kaliningrad region consumes most of its gas for electricity production). In any case, as long as the Nord Stream plans are not implemented, the ‘Kaliningrad card’ remains in the Baltic States’ hands.<sup>18</sup>

11 Nemunas Biknius, Chief specialist of Energy Resources, Electricity and Heat division at the Ministry of Energy, interview by author, 16 November 2009, Vilnius, Lithuania.

12 Dr. Petra Opitz, Manager at Deutsches Institut für Wirtschaftsforschung (DIW econ), interview by author, 18 December 2009, Berlin, Germany.

13 Proof of this is the current failure to contract (through a formal competition process) the ‘strategic investor’, which would construct and operate the proposed NPP in Lithuania.

14 In Lithuania, Gazprom owns 37% of shares in the gas importer and distributor Lietuvos dujos (Gazprom’s strategic partner E.ON Ruhrgas International owns 39%). The second largest gas importer and distributor Dujotekana is under informal Gazprom influence (through private businessmen closely associated with the Kremlin). In Latvia, Gazprom owns 34% of shares in the single gas importer and distributor Latvijas Gaze (E.ON Ruhrgas International owns 47%). In Estonia, Gazprom owns 34% of shares in the main gas importer and distributor Eesti Gaze (E.ON Ruhrgas International owns 33%). Further information may be obtained at: [http://www.osw.waw.pl/sites/default/files/GP\\_EU\\_en\\_.pdf](http://www.osw.waw.pl/sites/default/files/GP_EU_en_.pdf), accessed 5 October 2010.

15 Not to mention the investments required for such projects. Given the economic crises currently facing the governments of the Baltic States it seems hardly possible that they will find an opportunity to invest in energy infrastructure development.

16 Nemunas Biknius, Chief specialist of Energy Resources, Electricity and Heat division at the Ministry of Energy, interview by author 16 November 2009, Vilnius, Lithuania.

17 The Russian region of Kaliningrad is geographically separated from the rest of Russia and does not have a self-sufficient energy sector. It is therefore supplied with gas via Lithuanian territory.

18 Nemunas Biknius, Chief specialist of Energy Resources, Electricity and Heat division at the Ministry of Energy, interview



In trying to diminish the risks associated with the strategies of Gazprom and the Russian government<sup>19</sup> in the gas sector, the Baltic States are also insisting on the construction of new pipelines to transport gas to the traditional destinations in the EU. For instance, the “Amber project”, if implemented, could carry Russian gas to Europe through the Baltic States, thus avoiding Belarus.<sup>20</sup> The Baltic States also support the Nabucco and White Stream projects, as they are aimed at supplementing Russian gas with gas from the Caspian Sea region. It is understood in the region that both Nabucco and White Stream will hardly reach consumers in the Baltic States. Nevertheless, the diversification of supply to the European market as a whole should discipline monopolists and put a limit on gas prices in Europe. Consequently, this would strengthen the negotiating position of consumers and increase the overall amount of gas supplied to the EU. For the Baltic States this could make it possible to re-import so called ‘surplus gas’ through Poland from Denmark, Germany, Norway, Qatar (in the case that the LNG terminal in Poland is built) or even Russia.

In order to benefit from a diversified supply of gas to the EU market, the Baltic States are first of all striving to implement the gas interconnection projects, which would unite Estonia and Finland, and Lithuania and Poland, as well as to accelerate the Baltic Interconnector project, which would allow the import of gas from Norway via Finland.<sup>21</sup> Additionally, the Baltic States are also

discussing the possibility of constructing an LNG terminal in one of the Baltic States’ ports. If such a terminal is built, large LNG vessels could be used to supply LNG from Qatar, Nigeria or the Barents Sea. An alternative possibility is to use small LNG tankers, which sell on the LNG brought to the existing terminals in Western Europe (Ramboll Group 2009). Another possibility, which could at least allow the Baltic States to deal with short term risks, would be to construct a second underground gas storage or to increase the storage capacity of the facility located in Inchukalns, Latvia.<sup>22</sup> These storages could also be connected to the gas pipelines running to Europe. However, due to a very complex set of reasons, none of these projects has yet advanced past the completion of the feasibility studies.

The Baltic States’ dependence on Russia in the oil sector is not as threatening as in the gas sector. On the one hand, all three Baltic States are net oil importers, depending on Russia for approximately 90% of their supply. On the other hand, however, as was noted before, the Russian crude oil pipeline system is connected to the Baltic States’ ports and the refinery in Mazeikiai, Lithuania. Due to the lack of refining and shipping capacities, Russian companies are dependent on these capabilities.<sup>23</sup> As a consequence of this cooperation, some oil and oil products end up remaining in the Baltic States. At the same time, however, Russia is currently constructing new terminals (e.g. in Primorsk) and pipelines on its soil and is thus increasingly avoiding this transit through the Baltic States.<sup>24</sup> If Moscow succeeds in this endeavour, the Baltic States will lose both their leverage vis-à-vis Russia (Sleivyte 2008) and their income from transit fees, which represent 4-5% of GDP and up to 10% if transport services are included (Mauring/Schaer

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by author 16 November 2009, Vilnius, Lithuania.

19 Assuming that the Russian government’s strategy is to use energy resources as a tool for achieving political objectives. In this study, the strategy and policy of Russian energy companies and the government are considered to be very much interdependent.

20 The “Amber project” envisions the laying of a pipeline across the Tver, Novgorod and Pskov oblasts in Russia and then through Latvia and Lithuania to Poland, where it would be reconnected to the Yamal–Europe pipeline. Proponents have claimed that the Amber pipeline would cost only half as much as Nord Stream, would be shorter, and would have a less significant environmental impact. Critics of the proposal say that it would be more expensive for suppliers over the long term, as the main aim of the project is in fact, to reduce transit costs.

21 Finland is also interested in having a link with the Baltic States, as this would allow it to make use of Latvia’s underground storage facilities. The geological structure in Finland makes domestic storage very expensive to build.

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22 At present, the Inchukalns storage facility has a capacity of 2.3 bcm. This facility not only holds the gas reserves of Latvia, Lithuania and Estonia, but also those of Russia. The volume of Latvian underground gas storages could be increased up to a total of 20 bcm (KPMG Advisory 2008).

23 For example, the Ventspils terminal handles shipments of crude oil and petroleum products from Russia as it is linked to Russia’s oil extraction fields and transportation routes (Ventspils 2009).

24 A recently opened port in Ust-Luga (St. Petersburg district) and the “Baltic Pipeline System” are the most evident elements of such a strategy.

2006). On the other hand, the terminals located on their soil allow for the import of oil from destinations other than Russia.<sup>25</sup> For instance, the Kazmunaigaz Company uses some of these terminals for the export of Kazakh oil, which is transported to the ports by rail. Therefore it may be concluded that despite Russian efforts, due to their traditional intermediary role and current capacities in the refining and transportation processes, the Baltic States will most probably retain the possibility of diversifying their oil supply and even of using their oil infrastructure development projects as a catalyst for intensifying cooperation in other sectors.<sup>26</sup>

Besides these direct reasons (the absence of interconnections, the dominance of Gazprom in the gas sector and poor governmental investment capacity), there are also other, more indirect factors, which to date have prevented the Baltic States from effectively countering their energy security related risks. For instance, the construction of the new NPP in Lithuania was postponed several times, due to internal mismanagement<sup>27</sup> and the complicated relations with the Polish, Latvian and other partners (The Lithuania Tribune 2009: 17). There is also no excuse for the situation, which forced the Lithuanian government to appeal to the European Commission in order to convince Latvia to cooperate in energy affairs (as it was in the case of energy link to Sweden<sup>28</sup>). Even after the European Commission interfered, cooperation remained technical, on the level of operators, rather than orientated towards long term goals, such as a firm agreement that only one new NPP

will be built in the region.<sup>29</sup> Despite the fact that the Polish power company PSE Operator is one of the partners in constructing an energy bridge between Lithuania and Poland and the new NPP in Lithuania, the Polish government is worried about the competition, which local energy producers may face if these projects are completed. As a consequence, the Polish government is simultaneously considering the construction of several NPPs in Poland, negotiating the import of electricity from German NPPs and examining the possibility of supporting the construction of an NPP in the Kaliningrad region. Outdated energy infrastructure is another challenge. In the case of the construction of LitPolLink, the upgrading of Lithuanian and Polish domestic power grids would cost €95 million and €371 million respectively. Competing NPP projects in Belarus and Kaliningrad may only deepen the reservations of potential partners to invest into the modernisation of Baltic electricity grids and new infrastructure objects (The Lithuania Tribune 2009: 5).

To sum up, being more than once ‘punished’ by Moscow for their growing independence in foreign-policy making<sup>30</sup>, the Baltic States remain vulnerable in the gas and electricity sectors. National and regional cooperation efforts to mitigate these vulnerabilities appear to be important but not sufficient. Indeed, the last 10-15 years of action within this framework have not resulted in reliable solutions. There is a risk that in dealing only bilaterally at the governmental level, or leaving it up to private companies to implement essential energy security projects, may result in a further deterioration of the situation. In other words, it may put the ability to provide a

25 For example, after Russian companies stopped supplying oil through the “Druzhba” pipeline in 2006, oil to Lithuania (“Mazeikiu nafta” refinery) was imported from Venezuela (BNS 2006).

26 The best example of this is the Lithuanian-Polish cooperation around the “Mazeikiu nafta” refinery, which contributed to some progress on the Odessa-Brody-Plotsk-Gdansk pipeline, which aims to ensure the import of oil from the Caspian Sea region.

27 The national investor “LEO LT” was created to complete the project, only to be subsequently abolished.

28 After the European Commission stated its potential financial support for the “NordBalt” project, the Latvian and Lithuanian governments engaged in a competition concerning the place from which the energy cable linking Sweden should be built.

29 Nemunas Biknius, Chief specialist of Energy Resources, Electricity and Heat division at the Ministry of Energy, interview by author, 16 November 2009, Vilnius, Lithuania.

30 For instance, the Russian state-owned company “Transneft” attempted to gain control of the “Mazeikiu nafta” refinery in Lithuania and the Ventspils oil-export terminal in Latvia in 2002. When the two governments refused to sell their stakes to “Transneft”, Moscow sharply cut oil deliveries, forcing Ventspils to obtain oil by rail. Deliveries of oil to the Lithuanian refinery “Mazeikiu nafta” were cut after the refinery was sold to the Polish company “PKN Orlen” instead of the Russian “Lukoil”. Other notorious examples are the gas conflicts between Russia and Ukraine and the increase in gas prices for Azerbaijan, Belarus and Moldova (Spruds 2009).

stable supply of electricity at risk, further increase dependence on supplies from Russia and raise the price of energy for consumers.

However, with their reliance on a deepening of European integration in energy affairs, the Baltic States can not afford to remain passive spectators. In other words, they do not have a choice other than to be the ones generating innovative ideas and proposing pilot projects and reasoned initiatives. If not, 'common' EU policy will not necessarily mean 'beneficial' policy. For instance, although the liberalisation of the EU energy market was agreed, it was not implemented, nor was it extended to the creation of an external dimension. Moreover, it did not result in the creation of crisis management instruments or EU strategic energy reserves. Thus, the Baltic States should define their priorities and lead, together with their partners, a broader discussion on EU energy policy. The next chapter will explore how the Baltic States are attempting to streamline the EU common energy policy in order to make it more effective.

## II The Baltic agenda for the common EU energy policy

Officials and scholars in the Baltic States argue that by exploiting their current competences the EU institutions could play a crucial role in the creation of a common EU energy market, strengthening the EU's energy ties with 'alternative' energy suppliers, and negotiating the conditions of a strategic partnership with Russia in the energy sector. The majority of Western experts and officials, however, doubt the efficiency of involving supranational EU institutions in such matters. As a German expert puts it "the EC has a mandate in competition, infrastructure and climate policies, it can foster energy efficiency projects or promote renewable energy resources. But it does not possess a mandate to develop a comprehensive energy policy"<sup>31</sup>. Against this background the Baltic States face a twofold challenge: 1) to convince sceptics that a common EU energy policy can already be effective today; 2) to promote the further development of a common EU energy policy by arguing for the creation of common electricity and gas markets, and the strengthening of the external dimension. Both aspects are crucial, as important achievements are possible even without big structural changes in the EU *acquis communautaire*. For instance, political support from the EU could trigger the construction of important infrastructure objects and also encourage member states to continue reforms despite the pressure from monopolists. At the same time, amendments to the legal base and the creation of new legally binding commitments could ensure that once started, this process becomes irreversible and complements the energy security of each and every EU member state. The following two sub-chapters will discuss the Baltic States' priorities for the development of an EU common energy policy. These priorities include the creation of common EU gas and electricity markets and the diversification of gas supply. These are two areas in which the involvement of supranational EU institutions could, according to the Baltic States, bring a clear added value even in the short term.

31 Dr. Petra Opitz, Manager at DIW econ, interview by author, 18 December 2009, Berlin, Germany.

### *Creation of common EU gas and electricity markets*

The Baltic States' efforts to prevent politically motivated supply disruptions and constant price lifting are pointless, if the common EU electricity and gas markets do not work properly or if the Baltic States' energy sector stays outside this market. Being a part of the European market would mean a diversified supply, while staying outside means playing into the monopolists' hands, i.e. paying their price without negotiations, experiencing the pressure to sell energy infrastructure objects, and facing blackmail and disruptions due to political reasons or outdated infrastructure in the East (see chapter 1). The provisions of the Lisbon Treaty and more detailed EU regulations on the creation of a common EU energy market (e.g. third Legislative Energy & Gas Package) provide some hope and allow the Baltic States to have at least minor leverage against the growing influence of Gazprom. But this is not sufficient – the resulting common market is of no less importance than the process of its creation. The question remains as to why the process is so slow and how the Baltic States envision speeding it up.

The provisions laid down in the Lisbon Treaty are neither the first, nor the only attempt to employ transnational instruments to strengthen the EU member states' energy security.<sup>32</sup> In 2006, for instance, member states agreed on the priority projects inside the Trans-European energy networks (TEN-E).<sup>33</sup> The problem has been, however, that the construction of these networks has not received enough support from the EU institutions. In this regard, the Baltic States first of all argue for political support, which would be very helpful in attracting private investors, and the establishment of more favourable conditions for the development of the networks (e.g. for the adoption of fast approval procedures). According

32 According to the recently ratified Lisbon Treaty, competences in the field of energy policy are shared between the EU institutions and the member states (Official Journal of the European Union 2007: 21).

33 It was agreed that 9 major axes for electricity, 64 projects of 'common interest' and 32 projects of 'European interest' be included. The agreement also concerns the 6 major gas axes, 122 projects of common interest, 10 projects of European interest in the gas sector.



to a researcher from the Netherlands Institute of International Relations Clingendael, despite energy affairs being traditionally left for private companies to deal with, the latest attitude of the EU institutions represents a rift in EU thinking and favours the Baltic States' interests.<sup>34</sup>

Even with such political support, the creation of single, effective EU gas and electricity markets will remain little more than a vision if no investments are made on the ground. In other words, the creation of, or integration into, bigger regional or EU markets requires budget allocations for electricity and gas interconnections and the modernisation of energy grids and pipelines, amongst other things. However, the problem is that even after the ratification of the Lisbon Treaty, as regards financial matters, the member states continue to play a key role in the EU's energy affairs. This means that the costs of new energy infrastructure projects are mainly being covered either by national budgets or by private companies. The role of the EU is limited to the creation of a framework, which would stimulate private investment. This approach is problematic for the Baltic States, whose governments are not able to allocate sufficient resources and where companies are not willing to invest into financially risky projects, whether on their own or sharing the burden among several parties.

It is more than clear that EU financial mechanisms will not be used to make a significant contribution to the development of regional energy infrastructure projects if this idea is opposed by the largest EU member states. This fact explains the Baltic States' efforts to engage in extensive political dialogue with Germany, the UK and the Nordic States. Though they are far from making concrete achievements in the energy sector, the Baltic States' expectations are not completely unfounded. As highlighted by a German expert, Germany, for instance "is a country with the overall market guided philosophy and creation of the common free electricity and common market

could be one of its goals"<sup>35</sup>. On the other hand, a German researcher claims that in reality, the creation of a single EU energy market is more a rhetorical than a real priority for the German government. The main reason for this lies in the fact that German energy companies are not very keen on allowing outsiders to enter the German market. In addition, the German government is reluctant to finance the construction of interconnecting pipelines as part of the European Economic Recovery Plan, arguing that this would help encourage countries to free-ride instead of pursuing the projects on their own.<sup>36</sup> Nevertheless, as recent examples such as the creation of bail-out packages for Ireland and Greece and the discussions surrounding the European financial stability facility fund show, in the case of a really serious crisis, leading EU member states usually prefer to become active. This provides hope for the Baltic States' diplomats in their bargaining with the leading EU countries.

The financial aspects of creating an EU energy market are governed by the Decision „Laying down guidelines for trans-European energy networks and repealing Decision 96/391/EC and Decision No 1229/2003/EC“<sup>37</sup> (European Parliament and Council 2006). Initially, for the TEN-Energy projects, the EU Commission, with the Parliament's support, proposed €340 million for the financial period 2007-2013. The Council, however, insisted on a drastic reduction of these funds. The final agreement between the Council and the Parliament on the new TEN-E

34 Christof van Agt, Senior researcher at the Clingendael International Energy Programme, interview by author, 2 March 2010, The Hague, Netherlands.

35 Dr. Petra Opitz, Manager at DIW econ, interview by author, 18 December 2009, Berlin, Germany.

36 Marcel Viëtor, Program Officer for Energy and Climate at the German Council on Foreign Relations (Deutsche Gesellschaft für Auswärtige Politik, DGAP), interview by author, 10 December 2009, Berlin, Germany.

37 This document defines the conditions, methods and procedures for granting Community financial aid to projects of common interest in the field of the trans-European transport and energy networks (Inforce-Europe 2008). It is also mentioned that financing for the TEN projects can be complemented by structural fund assistance, aid from the European Investment Bank (EIB) or contributions from the private sector (ibid.). Despite the fact that financial support from the Community may serve only as a catalyst (with member states still required to cover the bulk of the costs), this option for financing the energy infrastructure development and integration into the EU energy market projects is the most desirable for the Baltic States.

financial framework provided only €155 million, which represents 45% of the amount originally proposed (Soave 2008). This very minor sum for energy infrastructure projects is about to be spent on supporting the feasibility studies of projects considered to be of 'European' or 'common' interest, according to the Guidelines for TEN-E from 2006 (European Commission 2007). However, the attention that leading EU member states pay to financial matters, discussed earlier, is not the only challenge in this regard. Another problem is that despite the fact that the Baltic States have no energy interconnections with other EU member states, very few of the planned energy links important to the Baltic States are included on the list of EU priority projects (the most important of these are listed in table 2). In other words, even a greater awareness on the part of the most powerful EU governments may only result in greater EU support to the energy grids of

the Western (but not Central) EU member states. Thus, the Baltic States must once again try to solve a twofold task: to increase the EU financial allocations for the creation of well functioning common EU electricity and gas markets and to ensure that the biggest investments are made on their soil.

The indifference of EU member states towards the creation of effective, liberal and common electricity and gas markets may be clearly illustrated by the fact that, out of 27 countries, 25 have not implemented the directives on the liberalisation of the electricity and gas markets correctly. However, concerns about the possible 'free riding' are not the only reason for not investing into interconnections. Investments are hindered by the right feeling that common effective EU electricity and gas markets will not function properly until the goals of the EU internal coherence and solidarity are overshadowed by

**Table 2. TEN-E projects relevant for the energy security of the Baltic States**

ELECTRICITY		GAS	
Priority projects	Projects of European interest	Priority projects	Projects of European interest
Denmark - Germany - Baltic Ring	Poland - Lithuania link, including necessary reinforcement of the Polish electricity network and the Poland - Germany profile in order to enable participation in the internal energy market	United Kingdom - northern continental Europe, including the Netherlands, Belgium, Denmark, Sweden and Germany - Poland - Lithuania - Latvia - Estonia - Finland -Russia	North European gas pipeline, Yamal - Europe gas pipeline, Natural gas pipeline linking Denmark, Germany and Sweden
France - Belgium – Netherlands –Germany			
Borders of Italy with France, Austria, Slovenia and Switzerland			
United Kingdom - continental and northern Europe	Submarine cable Finland -Estonia (Estlink)		Algeria - Spain - Italy - France -northern continental Europe
France - Spain – Portugal	Germany - Poland - Czech Republic - Slovakia – Austria - Hungary - Slovenia		Caspian Sea countries - Middle East-European Union (The Nabucco pipeline)
Greece - Balkan countries - UCTE System			LNG terminals in Belgium, France, Spain, Portugal and Italy
Ireland - United Kingdom	Mediterranean Member States - Mediterranean electricity ring		Underground storage in Spain, Portugal, Italy, Greece and the Baltic Sea region
		Mediterranean Member States - East Mediterranean gas ring	

*Source: European Parliament and Council 2006.*

the individual member states' preoccupation to maintain good relations with external energy players (whether real or potential electricity and gas suppliers). Due to this the third dimension of the Baltic States efforts concerns external factors, notably Moscow's resistance towards the creation of a free market in the Baltic region and the EU. In this regard the Baltic States point to the paradoxical situation that Western countries do nothing in order to 'convince' Gazprom to shift the Eastern border of the EU's gas market from the Western to the Eastern borders of Poland. Until this so called 'gas-up' happens on Poland's Western borders, the Baltic States are not considered by Gazprom to be a part of the 'European market'. This means that even if the necessary €343-778 million are allocated and the gas systems of Lithuania and Poland are interconnected, Poland or other gas companies in Western Europe still may not be allowed to re-export Russian gas back to the Baltic States. In this regard, it may be concluded that the development of an external EU energy policy dimension corresponds to the Baltic States' interests to the same extent as the creation of the common market does.

Matching the objectives of a common market with the aims of a common EU external energy policy may, however, be not so simple. As a Dutch researcher rightly claims, the ongoing debate on the external energy policy dimension is about deepening the intervention of governments either directly (e.g. investing into Nabucco) or indirectly (via fiscal measures or support for entrepreneurial activities in certain regions).

Analysts and politicians on both the EU and Russian sides rightly note that this sort of initiative (as for instance the unbundling foreseen in the third EU energy package) actually contradicts the free market philosophy. The Baltic States, being among the most prominent supporters of a securely functioning free common market, have a vested interest in finding and promoting a solution to this dilemma. One possibility would be the creation of a legal base, which includes new provisions on 'co-dependency'. This concept acknowledges the consistency of the external EU energy policy with the rules of the internal market, but goes beyond these if the free market does not

work in external relations with non market energy suppliers. In practical terms it means a repetition of the pattern set by the European Atomic Energy Community (Euratom), i.e. the creation of a similar 'community' for the gas sector. Since gas sector security issues do not compare to the much higher security standards that the trade and transport of nuclear materials requires, this currently appears to be an unlikely development. On the other hand, the *Declaration on the creation of a European Energy Community* (Andoura et al. 2010), which will be discussed below in more detail, is very well equipped to serve the Baltic States' political goals.

### ***Gas supply diversification***

Many Western experts consider the diversification of the supply of energy resources only to make sense if it is economically feasible. For instance, it is argued that if it is cheaper to import electricity from Russia than from another country (e.g. Finland), electricity should be imported from Russia. If Russian gas is cheaper than Norwegian gas or LNG, then again, Russian imports should prevail. Otherwise, consumers will have to share the burden of expensive projects by being forced to accept much higher energy prices.

Moreover, it is claimed that although diversification is the 'motto' of the day for politicians, the practical need for such strategies should not be overestimated. Indeed, there are other, EU-internal and therefore, more feasible means by which to increase supply security.

Nevertheless, the Baltic States continue to argue for the strengthening of the external EU energy policy dimension, which would help to diversify supply and break existing monopolies. There are irresistible arguments for doing so even today, when Western energy companies and scholars debate the possibilities of how to cut the price of wind and nuclear energy, how to increase the consumption of biomass, hydro- and geothermal energy, how to develop solar and hydrogen energy, and how to improve the technologies of horizontal drilling or rock fracturing in order to increase the production of 'unconventional' gas and oil.

The functioning of a free EU energy market would open up the possibility of gas and electricity

exchange among the EU member states. For the Baltic States this would make it possible to import gas and electricity from other EU member states and to rely on their networks for the supply of imports from more remote sources. As a consequence, prices would become negotiable. On the other hand, at least the partial diversification away from Russian gas and the pipelines through which it is supplied is possible even in the short term, without integration into the common EU market. Striving for this, the Baltic States rely on two important factors: 1) the fact that, officially, strengthening cooperation with both traditional and alternative energy suppliers is one of the EU's external energy policy priorities and 2) no EU country has given up the desire to diversify its supply of gas. In this regard, the starting point for the Baltic States in the gas sector is the construction of the Southern Corridor (Trans-Caspian, the Nabucco and the White Stream pipelines), as well as the contracting of suppliers in the Caspian Sea region (see annexe, figures 7). The Baltic States are also keen on preserving the independence and the speeding-up of the modernisation of the Ukrainian pipeline system, as well as on the construction of an interconnection between Poland and Lithuania. In this vein, it is important to ask what has already been done in this regard and what are the prospects of achieving more.

In 2009, after seven years of debate, the European Commission proposed €250 million in initial funding for the Nabucco pipeline. In the same year, Turkey and four EU member states signed a deal allowing work on this pipeline to start (Lobjakas 2009). In early 2011, Commission President Jose Manuel Barroso and Energy Commissioner, Günther Öttinger, personally visited Baku and Ashgabat confirming the EU's determination to gain access to Caspian energy resources and attempting to specify the scope of the proposed Southern Corridor together with Azerbaijan (the only reliable gas supplier for the Southern Corridor route). Nevertheless, problems related to the construction of Nabucco remain fundamental. Although the launch of the Southern Corridor on the basis of Azeri gas is at present a near-certainty, it has not yet been established via which route or under what conditions will the gas

be transmitted to the EU. In practice, Azerbaijan will decide on the scope and route of the corridor, on the basis of its own calculations (Jarosiewicz 2011). At the same time, however, the corridor is bringing various other conflicting interests to the fore: as a strategic transit hub, Turkey is pressing the EU to accept its EU membership application; Germany, Italy and France question the necessity of Nabucco; and Russia is about to implement competing projects (Liuhto 2009). The White Stream and the Trans-Caspian projects are experiencing similar problems and are even less advanced than Nabucco. Thus, the Baltic States' diplomatic efforts in this area have not resulted in any tangible results so far.

The prospects of advancing the diversification of gas imports to the Baltic States from other regions are even vaguer. The construction of new undersea pipelines is not under consideration and the shipping of LNG is not feasible due to the absence of LNG import facilities in or around the Baltic States. Poland has taken some practical steps in this direction by implementing an LNG terminal construction project in Swinoujscie and has already signed a deal with Qatar's Qatargas Operating Company to deliver about 1.4 bcm of gas through the terminal starting in 2014. However, for the Baltic States to benefit from this, a completely new 820 kilometre pipeline would have to be built from Poland to Lithuania. Therefore several 'internal' LNG infrastructure development projects are also being discussed. The Lithuanian government is currently exploring the idea of constructing an LNG import terminal in Klaipeda, Latvia has plans for an LNG terminal in Ventspils and Estonia envisions the construction of a terminal in Paldiski (Esmerk 2009). However, the costs of the LNG import terminals, as well as other economic and financial factors (the tight market, the price of LNG), are forcing the Baltic States to look for more creative solutions.

A significant share of the obstacles to gas supply diversification, however, are related to the Gazprom factor. For instance, Gazprom has announced its desire to participate in the construction of the Nabucco pipeline (Interfax 2006), which could contradict the concept



of diversification and prevent some potential investors from investing into this project.

Even greater damage may be caused by the fact that Gazprom has managed to sign long term contracts on all possible supplies of gas from gas producing countries such as Turkmenistan and Azerbaijan. In this way, Gazprom has managed not only to make a profit from transit fees, sustain its own energy exports to the EU and even develop plans for serving China's growing energy needs, but also to prevent direct cooperation between the EU and Central Asia in the energy sector (Burns/Houman 2009). In this context, it is important to keep in mind Russia's strategy of signing bilateral agreements with potential Nabucco transit countries regarding their participation in competing projects and its ambitions to enter the LNG market. Finally, it should be recognised that the EU does not have too many instruments to prevent LNG from becoming just another 'pipe', which once again may become dominated by Gazprom. This could easily happen if the Russian guided Gas Exporting Countries Forum (GECF) becomes stronger and turns into an LNG cartel. The Baltic States' tactic of engaging the EU institutions in this competition or at least in negotiations with Gazprom over alternative supply options has not yet brought about any significant results.

To sum up, the lack of will at the European and national level, insufficient financial mechanisms and active external resistance serve as serious obstacles to the creation of common electricity and gas markets and the diversification of supply. At the same time, there is no foolproof prescription on how to overcome these structural problems. Nevertheless, the Baltic States will most probably continue to require that the Union does everything possible in order to extend the provisions of the common market beyond its current borders as soon as possible. They will also continue to insist on the development of the external dimension of the EU common energy policy, which is so crucial for the diversification of supply. The joint *Declaration on the creation of a European Energy Community* by Jerzy Buzek, President of the European Parliament, and Jacques Delors reads: "Europe needs a stronger, deeper, common energy

policy" (Andoura et al. 2010). In the wake of this initiative, the Baltic States will try to secure political support for any other proposal suggesting a response to Gazprom's dominance. It is the Baltic States' task to ensure that similar proposals find a place on the EU's political and economic agenda.

What the Baltics want is that the EU stands up for its members and prevents such developments from entering long term contracts that other members consider problematic. Therefore the next chapter will focus on the principle of 'solidarity' which is essential but so far has not been fully implemented. 'Consumer solidarity' has not become a concept found in multilateral energy instruments, such as those related to the external dimension of common EU energy policy, or in secondary EU legislation on energy affairs. This is a situation, which the Baltic States are trying to amend. It also focuses on the Baltic States' tactic of questioning the wisdom of a policy based on denying access for undertakings from third countries that do not reciprocate by allowing market access to their own national systems. Thus, the development of a unified approach towards internal solidarity and reciprocity between the EU and Russia, as the EU's largest external supplier of fossil fuels, are at the centre of the third chapter.

### III The Baltic States' priorities for EU-Russia energy cooperation

In 2009, Russia withdrew its commitment to provisionally apply the Energy Charter Treaty (ECT), an agreement regulating investment protection and transit in the energy sector in Europe and the Commonwealth of Independent States (CIS). In addition, Russia is neither a member of the World Trade Organisation (WTO) nor a signatory to any other international economic agreement (Dreyer et al. 2010: 1). In other words, there is no international legal instrument to limit Moscow's actions in the field of energy policy. As a consequence, the Russian government may use national energy 'champions' for the implementation of its foreign and security policy without obstacles, for instance, by streamlining energy resource export and pricing policy. Such a strategy would negatively affect the effectiveness of a common EU energy policy and is a constant source of worry for the governments of the Baltic States. This chapter will focus on the Baltic States' agenda towards shaping possible internal and external EU responses, which, if successful, could lead to a situation where relations with Russia do not determine the conditions of access to Russian gas.

#### *Shaping 'consumer solidarity'*

It is widely recognised that without internal coherence, an effective external energy policy dimension is practically impossible. It is also a fact that today, the EU fails to speak with a 'common voice' in energy affairs (Braghiroli/Carta 2008). Long term bilateral energy agreements, such as Nord Stream between Russia and Germany, South Stream between Italy, Bulgaria and Russia and various LNG supply contracts between Spain, France and Algeria, indicate that big member states continue to view energy security as a national policy issue. A German expert claims that some countries recently started to understand that they are gaining little out of the strategy to 'play' bilaterally with Russia.

Nevertheless, politically and economically, EU member states continue to favour the use of bilateral and 'non-institutionalised' (i.e. not regulated by an

'all inclusive' international treaty) relations with external suppliers, as long as they feel that their own bargaining power is greater or equal to that of their suppliers. What is even worse is that the Baltic States' voice arguing for a strengthening of EU energy cooperation with the Caspian and Black Sea region countries is going almost unheard. Recognising their limited influence in bilateral talks and the absence of means to manage energy supply related crises, the Baltic States' governments have discovered another tactic on how to deal with energy insecurity. The main element of this is to argue for the construction and strengthening of EU solidarity in energy affairs (Vaicunas 2009).

The Baltic States have drawn an interesting conclusion regarding the main causes of missing EU solidarity. It seems that the main constraint is not the opposition of some member states to the concept of 'solidarity' in energy affairs, but different perceptions inside the EU on what 'energy solidarity' actually means. Consequently, building a consensus has turned into the main task for the Baltic States. These various perceptions are determined by the different 'starting positions' of the EU member states. Respective starting positions are influenced by factors such as the different attitudes towards the liberalisation of the energy market, different geographical locations, different energy mixes and levels of dependence, and different historical experiences.<sup>38</sup> Therefore some EU member states perceive 'solidarity' first of all as a short term action in times of crisis that is, as an ability and willingness to support other EU member states in case of short term supply disruptions. German researchers for instance argue that the solidarity clause is important for the German government, but Germany's energy companies do not maintain any considerable interest in investing into unprofitable, solely politically motivated projects.<sup>39</sup> Moreover, some

38 Marcel Viëtor, Program Officer for Energy and Climate at DGAP, interview by author, 10 December 2009, Berlin, Germany; Dr. Franziska Holz, Researcher at the Department Energy, Transportation, Environment, German Institute for Economic Research, interview by author, 8 December 2009, Berlin, Germany.

39 Jonas Grätz, Doctoral Fellow, Stiftung Wissenschaft und Politik, Russia/CIS Division, interview by author, 15 December 2009, Berlin, Germany.

## Box 1: Examples of missing EU solidarity in energy affairs

### Case 1 – Nord Stream

Nord Stream is a gas pipeline that aims to link Russia and the European Union via the Baltic Sea. Nord Stream is a joint project between four major companies: Gazprom, BASF/Wintershall Holding AG, E.ON Ruhrgas AG and N.V. Nederlandse Gasunie. The pipeline will be 1,220 km long and will consist of two parallel lines with an annual capacity of around 55 bcm. Total investment in the offshore pipeline is projected at €7.4 billion. Work on the project could only begin once those countries in whose exclusive economic zones the pipeline is routed had granted their permission. There was no doubt that Russia and Germany would issue such permission, but the Baltic States expected support from the Nordic countries. All the more so because Finland and Sweden had repeatedly expressed concern about the environmental impact of the project and Stockholm was additionally worried that the pipeline might be used by Russia as a good excuse for it to militarise the Baltic Sea. In addition, Denmark expressed its concern over the project's possible impact on Bornholm. Nevertheless, by the end of 2009, the governments of Denmark, Finland and Sweden had agreed to the construction of Nord Stream, despite all of these possible economic, political, ecological and technological risks. The fact that Helsinki obtained Moscow's pledge that Russia would not increase export duties on unprocessed timber for one year demonstrated the circumstances under which the majority of the Nordic states accepted Nord Stream.

### Case 2 – South Stream

The South Stream project was initiated by Russian Gazprom and Italian ENI in 2007. Subsequent bilateral diplomacy on the part of Gazprom managed to involve additional EU member states, namely Greece and Slovenia in the project and to secure the support of others, who could potentially benefit if the project is implemented. The Baltic States argue that the South Stream pipeline was initiated by Gazprom in order to control the flow of natural gas from the Caspian region and the Middle East to Europe. In other words, they fear that the EU may refuse to compete with Russia and may switch the gas supplies for Nabucco from Central Asia and the Caspian Region allowing Russia to transport Central Asian gas through the South Stream pipeline. Thus, if Russia succeeds in constructing South Stream, Gazprom will control the entire gas supply, at least to the Balkans and the CEE region a) from Central Asia (by controlling South Stream) and b) from Middle Eastern countries (by "coordinating" supplies through GECF). To sum up, according to the Baltic States, if the countries joining South Stream and defecting from Nabucco in favour of South Stream (Austria, Hungary, Bulgaria) continue to base their energy policy only on opportunistic, economic calculations, Russia will be able to conceal the deficit of its own gas production without investing into energy efficiency and upstream infrastructure.

*Source: Information in the box was prepared using: Paszyc 2010.*

experts underline the German government's unwillingness to spend tax payers' money on European interconnecting pipelines or energy bridges for reasons related only to the 'security of supply', in other words, with no regard for who will supply these pipelines or energy grids with gas or electricity.<sup>40</sup>

However, for the countries of the CEE region 'solidarity' means more than whether or not investments are made into concrete pipelines. Their strategic long term goals include the creation of a 'harmonised energy policy' towards external suppliers and transporters, the financing of key energy infrastructure projects from the EU budget, and even some type of 'collective security' commitments in the energy sector. Asking for solidarity, the Baltic States are trying

40 Marcel Viător, Program Officer for Energy and Climate at DGAP, interview by author, 10 December 2009, Berlin, Germany.

to upload to the EU their worries about the Kremlin's national priority to strengthen Russia's role in the world energy market. They argue that Moscow's endeavour to gain state control over the pipelines, as well as the increasing role of Russian companies on the European energy market and Russia's closer cooperation with South Korea, China and India on oil and gas matters, should be perceived as Russia's ambition to become a leading energy superpower and to use this status to improve its standing in European and global politics. In other words, the Baltic States are afraid that Russian energy policy is becoming an instrument for a "new Russian imperialism" (Aalto 2008: 147). The main elements of this policy are: close control of foreign investment<sup>41</sup>; direct ownership of strategic energy assets<sup>42</sup>; increased participation in oil and gas exploration in the post-Soviet countries, in the Middle East as well as in Africa, Asia, and South America<sup>43</sup>; avoidance of transit countries<sup>44</sup>; concentration on long term gas supply contracts<sup>45</sup>; and the threat

to diversify its gas market from Europe to Asia.<sup>46</sup> The Baltic States would like Western Europeans to recognise this threat as a common threat for the EU. However, so far, Western European states have not shared these concerns.

Due to the different perceptions of 'solidarity', the latter has become a hardly achievable objective. For instance, it is widely recognised that Russian companies act as the 'gatekeepers' to the Russian energy market and that the disparity in the rules, which regulate the EU's energy market on the one side and Russia's on the other, is huge (Grajauskas 2008). However, according to both German and Dutch experts, there is only a small hope that the EU and Russia can reach a legally binding strategic agreement, because such an agreement would first require all EU member states to demonstrate solidarity with one another. Consensus between small and large member states is hardly possible, as the current state of the legal framework (or the absence of it) in fact satisfies the interests of the largest EU energy companies, who are the main players in the national energy sectors. German, French and Italian companies are competing with each other to receive better import conditions; they manage to negotiate access to the Russian upstream energy market and would not like to give up this power to, for instance, the European Commission.<sup>47</sup> In this context, instead of engaging the Baltic States' energy companies in negotiations with external suppliers, Westerners tend to criticise them for refusing to pay the energy infrastructure development related bills or for unfair attempts to profit from transit fees (as an opposing example of this, the Czech Republic's

41 In recent years, several foreign companies – such as Shell, Mitsui, Mitsubishi and BP – have faced abuses in Russia. For more details see: [http://www.forbes.com/2007/02/16/bp-russia-energy-markets-equity\\_cn\\_0216markets11.html](http://www.forbes.com/2007/02/16/bp-russia-energy-markets-equity_cn_0216markets11.html), accessed 5 October 2010.

42 Russia insists that foreign companies wishing to take part in oil and gas exploration in Russia, should offer their Russian partners "something in exchange" on their home market (Mae 2009).

43 Russia is using outright ownership and joint ventures to control the supply, sale, and distribution of natural gas and is buying up major energy infrastructure assets, such as pipelines, refineries, electric grids, and ports. As of 2004, Gazprom had invested \$US 2.6 billion in 23 major joint ventures and was buying up strategic infrastructure companies in Georgia, Hungary, and Ukraine. In 1998, Gazprom took over shares in "Topenergy", a Bulgarian company dealing with the commercial distribution of gas (Amsterdam 2007).

44 Examples include the cancellation of the Yamal II pipeline that was to be built parallel to Yamal I through the territory of Belarus and Poland, the postponed Amber project, which was intended to create a pipeline running through the Baltic States and Poland, and the decision to build Nord Stream, which will bypass all the mentioned countries. The development of the Shtokman gas field is also partly driven by a strategy of avoiding transit countries, as gas from this field is to be transported directly to Russia's gas customers either through a pipeline going via Russia and then through Nord Stream or as LNG from the LNG plant that is to be built just East of Murmansk. To reduce dependence on the use of the Baltic ports, Russia is currently building ports on the Northern shore of the Baltic Sea (Grajauskas 2008).

45 Since the 1970s, the supply of natural gas has been based on long term contracts agreed for a period of 15-20 years, in order

to share the risks of costly pipeline construction and resource development between producers and consumers (Janeliunas 2009).

46 For instance, in February 2009, Russia and China signed an intergovernmental agreement on the construction of a pipeline branch from Skovordino to the Chinese border and long term Russian oil supplies of 110 million barrels of crude per year from 2011 until 2030. On the other hand, Asian markets will be more expensive to develop, therefore Asian markets may be difficult for Russia to dominate (Ziegler 2009: 22).

47 Jonas Grätz, Doctoral Fellow, Stiftung Wissenschaft und Politik, Russia/CIS Division, interview by author, 15 December 2009, Berlin, Germany.



effective energy policy is often mentioned).<sup>48</sup> As a practical manifestation of this ‘solidarity misuse’, the resistance to the construction of the Nord Stream pipeline is sometimes cited.<sup>49</sup>

On the other hand, it should also be recognised that many Western European governments are going through a certain learning process and are gradually changing their attitudes towards the need for cooperation with the smaller EU members. Germany, for instance, was rather sceptical about the importance of having broader discussions and consensus inside the EU when energy agreements with Russia were at stake a few years ago.<sup>50</sup> Today, German politicians are keener to take into account the attitudes of Poland and the Baltic countries. They tend to understand the necessity to include or at least to consult these countries before starting new cooperation initiatives with Russia.<sup>51</sup> In this regard, Kai-Olaf Lang adopts a rather broad definition of solidarity in energy affairs claiming that today it means to give “support in overcoming the structural weaknesses and fragmentations of the market by providing (among other things) financial assistance to infrastructure projects”<sup>52</sup>. At the same time, however, this does not mean that the representatives of German companies will suddenly agree to solve the problems of those, who “haven’t done their homework”. Nevertheless, it is a much broader definition than the ‘short term action in time of crises’.<sup>53</sup>

The Baltic States’ objective of reaching a consensus on the definition of ‘energy solidarity’ has become more plausible since the ratification of the Lisbon Treaty. After the completion of some

important structural changes, Catherine Ashton, High Representative for Foreign Affairs and Security Policy of the EU, now has the opportunity to become the first real strategic embodiment of the EU’s ‘single voice’ in terms of foreign and security policy, which also includes energy policy towards external suppliers. New Commissioners, in particular those responsible for energy and climate, are also starting to play a very important operational role in ensuring that the EU improves the functioning of the internal energy market and that external energy resources are secured by different means. All these developments represent a ‘new momentum’ and it would be inexcusable if the Baltic States fail to capture this and to provide solid arguments in favour of the EU putting in place a mechanism reflecting a real EU ‘solidarity’ in energy affairs.

One of the main tasks for the Baltic States in the current circumstances is to build an appropriate explanation of why the EU bodies (Commission, external policy officials, structural funds, etc.) or ‘national champions’ in the energy sector should contribute considerably to the energy security of the Baltics. The repetition of *clichés* such as ‘EU solidarity’ and ‘energy island’ appears to be insufficient and therefore ineffective. It may be expected that in the future, the Baltic States will shift towards stressing solidarity as a factor implying political security and having a broader impact on stability in Europe. It may also be expected that the Baltic States will continue to explain the need for European investments, as local monopolies under companies closely aligned to Gazprom are not likely to make decisions to invest into additional energy infrastructure. To a certain extent, the Baltic States are right. Allowing Gazprom to takeover the Baltic States’ key energy assets was also the fault of EU market regulators.<sup>54</sup> Asking the EU to address the consequences of this and to prevent the abuse of these negative developments should now become the subject of internal or governmental debate. On the other hand, persuading the EU member states that the Baltic States’ interests (to prevent or even roll-

48 Marcel Viător, Program Officer for Energy and Climate at DGAP, interview by author, 10 December 2009, Berlin, Germany.

49 According to this logic, it is claimed that the countries resisting the construction of the pipeline simply do not want to lose their incomes from gas transit and that this has nothing to do with “solidarity in energy affairs” as such (Hamilton 2008).

50 Martin Kremer, Senior Fellow, Stiftung Wissenschaft und Politik, Research Division EU Integration, interview by author, 4 March 2010, Berlin, Germany.

51 Marcel Viător, Program Officer for Energy and Climate at DGAP, interview by author, 10 December 2009, Berlin, Germany.

52 Kai-Olaf Lang, Deputy Head of Research Division EU Integration, Stiftung Wissenschaft und Politik, interview by author, 24 February 2010, Berlin, Germany.

53 Ibid.

54 Christof van Agt, Senior researcher at the CIEP, interview by author, 2 March 2010, The Hague, Netherlands.

back the monopolisation in energy affairs) are in line with those of the EU might become quite a complicated process.

### ***Promoting ‘reciprocity’ and legally binding agreements***

Russia supplies around 25-30% of total EU oil and gas consumption and serves as an important motor for Europe’s economic growth. By 2020 the EU will need to import approximately 600 bcm of gas, up from ~ 400 bcm today, and at least half of this demand will have to be sourced from Russia (Weafer 2009). Thus, the possibility that Russia will diversify its gas exports in the future is rightly considered to be a threat to the security of Europe’s gas supply (Poussenkova 2009: 9). In addition, as much as 90% of Russia’s total natural gas exports are delivered to the EU. Adding together exports of oil and other raw materials, Russia’s energy exports to the EU account for roughly 75% of Russia’s total export earnings and 40% of Russia’s budget receipts (Perret 2007). In other words, the European market is crucial for Russia and neither Asia nor North America will serve as a reliable alternative for Gazprom in the foreseeable future.<sup>55</sup> For many Western experts these circumstances imply a ‘mutual interdependence’. The problem is that the Baltic States think differently.

Lithuania, Latvia and Estonia recognise that “even though ‘love’ between Russia and the EU most probably will not emerge, the necessity for cooperation will remain.”<sup>56</sup> Nevertheless, they claim that real reciprocity in EU-Russia energy relations is missing, due to the unequal weight of the two players. In other words, Russia’s vulnerability compared to that of the EU is much lower, as it can shift current oil flows easily and gas exports are relatively unimportant as a source of revenue for the Kremlin (Grajauskas 2008). Besides this, relevant Russian actors are capable of acting in unison and strategically, while the EU is internally divided, both structurally and

institutionally (Grätz 2009). Whereas Russian strategic energy interests are usually represented at the highest political level, with the President or government taking all strategic decisions, within the EU and its individual member states, they are represented at the level of private companies. This secures Russian companies the possibility to penetrate into the EU gas market. Russian firms usually not only succeed in securing a direct presence in the EU gas market, but also avoid competition<sup>57</sup> and enjoy the highest profit margin (Aalto 2008: 60).<sup>58</sup>

Another tendency, which worries the Baltic States, is the Russian endeavour to ‘coordinate’ the gas policies of the leading gas exporting countries through measures such as the construction of new pipeline projects, the ‘joint’ exploration and development of gas fields and the coordination of production schedules. As proof of this, in December 2008, Russia, Qatar and Iran formally inaugurated the GECF. Russia was the initiator of this forum and views it as a mechanism for attracting more investment funds into its gas industry and establishing Gazprom as a major global force in the LNG business (Weafer 2009). The GECF has since enlarged and now includes Algeria, Nigeria, Libya, Egypt, Trinidad and Tobago, Venezuela, Russia, Iran, Qatar, Oman, the United Arab Emirates, Brunei, Malaysia, Indonesia and Norway (as observer) (Hallouche 2006). Members of the GECF exchange views and information on project developments, supply and demand balances, exploration, production and transportation costs, etc.<sup>59</sup> As such, the GECF

55 It is said that Russia will not be willing to miss out on the world’s biggest market (500 bcm/year) for relatively small Asian (China and India need 80 bcm/year) or North American (140 bcm/year) markets.

56 Marcel Viëtor, Program Officer for Energy and Climate at DGAP, interview by author, 10 December 2009, Berlin, Germany.

57 For instance, Moscow knows that some suppliers are seeking to open or broaden their access to Western markets. Therefore, Gazprom is trying to establish permanent control of markets, such as those of Hungary and the Balkans, that are strategically important for transportation before Caspian gas can reach them through the Nabucco pipeline (Socor 2008).

58 The distribution business is one of the most profitable, while the upstream market requires the most investment.

59 While the weight of the forum in the global pipeline gas trade is not that pronounced (about 38%), its share of LNG production and exports was around 85% in 2007. In contrast, OPEC’s share of world oil supply is barely half that, at about 43%. However, it is still too early to say that a ‘gas cartel’ similar to OPEC has been created. The GECF membership has not been stable nor are all gas exporters members of the GECF. The behaviour of key members may have an important, but not always positive, impact on the GECF in the future. Finally, Russia can not afford

clashes with the 'free market' approach and competition policy promoted by the EU. Indeed, it makes contracting new exporters without consulting the dominant GECF member (Russia) extremely complicated.

In this situation, the Baltic States have no other choice than to endeavour to convince their Western partners that it is necessary to continue negotiations with Russia regarding a new legally binding agreement in energy affairs. Even though in the short term, the Russian government may discard proposals coming from the EU, a so called 'U-turn' in Russian energy policy is not inconceivable. This assumption is based on the fact that Russia's energy sector lacks investment and, what is even more important, that consumers do find alternatives to Russian energy resources. The construction of new LNG terminals, as well as the latest developments in the shale gas sector, have, in fact, already led to a change in the negotiating position of the Russian government and Gazprom in particular. Russian officials have become less assertive and more compliant to international policy frameworks, as they have come to understand a simple truth: the continuation of a strategy, which scares away both customers and investors, may result in the loss of a large portion of possible income from oil and gas production. The first practical consequences of this have already appeared. Gazprom previously claimed that it would supply the EU with 20% of its gas needs (the rest would be exported to China and the US), but now states that it wants to supply 30%. In other words, Gazprom has started worrying that it will lose even this 20% of the EU market. It seems that the Kremlin has become concerned by recent tendencies and may agree to some concessions.<sup>60</sup> Due to this, it may be expected that Russia will soon become interested in reaching an agreement with the EU. The Baltic States should do everything in order to ensure that the EU does not miss the opportunity to conclude it.

While discussing the content and the essence

of a potential EU-Russia agreement in the energy sector, the Baltic States would prefer that the EU does not walk away from the ECT as the integral, comprehensive energy agreement. However, in April 2009, Russian President Medvedev submitted a document entitled *A Conceptual Approach to the New Legal Framework for Energy Cooperation (Goals and Principles)* to the European Commission containing Moscow's proposals for a new set of rules under which the global energy market should operate.<sup>61</sup> The EU has indirectly responded to Russia's proposal by reaffirming that regulation of the European market would be based on the ECT (Paszyc 2009). But the problem here is that both parties (the EU and Russia) are fairly limited in their ability to make compromises on their market views, especially in the gas sector. Western experts seem to agree that the proposals set out by the Russian President should be taken on board. The added value of negotiations would then be to remain involved and to preserve a space for further discussions with Russia. Westerners would most probably even accept the 'return' of Russia to this treaty without the strategically important Transit Protocol.<sup>62</sup> Article 7 (dealing with transit issues) of the ECT is quite wide and legally speaking sufficient to deal with transit issues.<sup>63</sup> The Baltic States' task is to find and propose solutions in this complicated situation.

As Russia's objection makes proceeding with the ECT an extremely complicated task, one feasible solution (however, not yet articulated even

61 This document is sometimes also called 'Medvedev's Concept' and proposes rules which run counter to the liberalisation of the EU energy market planned by the European Commission and the provisions of the Energy Charter. It demands, inter alia, guarantees and predictability of sales (this means that priority is given to long-term contracts as a key factor in ensuring energy security), the protection of investments as well as "non-discriminatory access to international energy markets" (which could clash with EU plans to separate supplies and distribution in the EU market). Another proposal concerns the obligation to co-ordinate energy policies, including infrastructure projects (Paszyc 2009).

62 Christof van Agt, Senior researcher at the CIEP, interview by author, 2 March 2010, The Hague, Netherlands.

63 In essence, the Russian side supported the Transit Protocol, as it better accommodates Russia's strategic interests than Art. 7 of the ECT. After the failure of this 'strategy', the Transit Protocol remained unsigned.

to fund a world-wide increase of LNG consumption nor does it want to (Kavalov et al. 2009).

60 Christof van Agt, Senior researcher at the CIEP, interview by author, 2 March 2010, The Hague, Netherlands.

by the Baltics) is to look for a ‘specific agreement’ with Russia, without distancing the demands of this new agreement too far from those of the ECT. Other ‘specific agreements’, such as the agreement between Norway and the International Energy Agency could serve as a template. In any case, such an alternative agreement can only become possible if Moscow departs from its prejudice that the rest of the world has very few alternatives to secure its energy supply and therefore, that Russia does not need any legally binding agreements with the EU.

While waiting for a real shift in Russia’s thinking to occur, the Baltic States are concentrating on the construction of the internal EU legal framework, which would be applied to external suppliers.<sup>64</sup> They adopted the third Energy Liberalisation Package without any exceptions or transiting periods (Grajauskas 2008). Russia has voiced its opposition to the clause and received strong support from eight EU countries led by France, Germany and Italy (Dimireva 2009). These countries refused to take the path of so called ‘full ownership unbundling’, in which a parent company sells its transmission networks to a different firm.<sup>65</sup> Requirements for vertically integrated companies were softened: they were obliged to meet rather vague ‘effective unbundling’ and energy security criteria, which would be assessed by both national regulators and the European Commission (Grajauskas 2008). Although in practical terms the difference might prove to be not very significant<sup>66</sup>, the Baltic States

are very much disappointed with this outcome. They argue that while the EU tries to address the reciprocity problem at the macroeconomic level by setting equal conditions for all representatives of the sector, Russia continues an effective policy at the microeconomic level, looking at specific deals beneficial to Russian companies. According to the Baltic States, being dubious about the need to unbundle EU energy companies in fact encourages Russian companies to increase pressure and to deal with different member states separately.<sup>67</sup> This kind of relationship goes back to the ‘barter reciprocity’ so unacceptable for the Baltic States, where energy assets become objects of barter exchange<sup>68</sup>, and have nothing to do with ‘mutual interdependence’ or ‘strategic reciprocity’.

64 The initial proposal by the Commission clearly stated the principle that any company from a third country would need to “demonstrably and unequivocally comply with the same unbundling requirements as EU companies”. This means that third countries, such as Russia, would need to make similar reforms in their home market, before companies from these countries could make any significant downstream asset purchases in the EU (Goldirova 2008).

65 Germany, Italy and France oppose the deal, as they all have national utility companies with substantial foreign ownership. The Netherlands took an action to secure strengthened protection for their own energy sector in a separate deal. The same was also done by Denmark, Sweden and the UK, making it impossible for the law to make it through the EU parliamentary process (Goldirova 2008).

66 According to the initial agreement, despite the need to enforce liberalisation measures at home, companies of a third country could, in ‘special’ cases, participate in the EU market anyway.

Now, third country companies are allowed to participate, unless a national regulator and the Commission decide otherwise (Grätz 2009).

67 As proof may serve Gazprom’s official claims that the Lithuanian decision to separate sales and transmission activities hurt its investment in the country and that implementation of ownership unbundling could cause disruptions of gas supply. For more details see: <http://www.bloomberg.com/news/2010-09-30/gazprom-e-on-should-redirect-unbundling-complaints-to-eu-lithuania-says.html> , accessed 5 October 2010.

68 For example, a country would allow Gazprom greater access to its energy market to be sure that its energy giants secure energy deals with Russian companies.



## Conclusions

As was demonstrated in the first chapter of the paper, the Baltic States, together with Finland, are the only continental EU member states not integrated into the EU gas network and with only a modest connection to the EU electricity system. Due to the very slow progress in developing renewable energy, catastrophic energy efficiency and dependence on gas and oil imports from Russia, the Baltic States permanently face the threat of an energy shortage. It was also shown that the Baltic States often become the victims of the Russian government's tactics to use its energy companies or their export strategies as a form of political leverage.<sup>69</sup>

The second chapter demonstrated that the Baltic States have a more or less clear vision on what kind of common EU energy policy could help them by tackling the most serious challenges in energy security affairs. The top objective in this regard is to channel the Baltic's worries and proposals to the bigger EU member states and to in this way speed up the creation of functioning EU electricity and gas markets and the diversification of resource supply. Practically it means the creation of a legal framework for diminishing monopolists' power and support in developing strategic infrastructure projects, such as electricity and gas interconnections with Western and Northern Europe.

In creating a functioning EU electricity and gas market, the Baltic States are trying to convince all EU member states to live up to the letter of the document "Energy Policy for Europe", which puts "a truly competitive, interconnected and single Europe-wide internal energy market" at the heart of Europe's energy policy (European Commission 2007). As far as diversification is concerned, the Baltic States encourage the EU to take

responsibility and develop external relations with potential oil and gas suppliers and transit countries from Eastern Europe, the South Caucasus, Central Asia and the Middle East.

However, despite the Baltic States' hopes for a common European voice and despite positive public opinion in the entire EU<sup>70</sup>, governments and private companies in Germany, Italy, the Netherlands, France, Finland or Denmark prefer to deal with the external energy suppliers on a bilateral basis. These countries, which are crucial to the common EU energy policy, tend to believe that bilateral cooperation is more effective for securing sufficient energy supply. As was also shown, many EU governments consider a common EU external energy security policy, including a common vision towards EU-Russia energy relations, as ineffective and worry primarily about the possibility of 'engaging' and 'modernising' undemocratic suppliers in order to avoid gas supply disruptions in the future. In this regard, the Baltic States are advised to concentrate on national and regional non-political, but economically highly beneficial measures, such as informing people on effective consumption habits, setting up a framework for developing alternative energy resources, integrating national electricity and gas markets and constructing certain energy infrastructure objects.<sup>71</sup>

Nevertheless, the Baltic States hope to make use of the fact that they have participated in the common EU energy policy from the very beginning.

69 The easiest and most common way to manipulate the internal political situation in Lithuania, Latvia and Estonia is by supporting local (but close to Gazprom or other Russian monopolies) energy companies or businessmen who are asked to 'invest' their financial surplus into local politicians or political parties. Subsequently, these political actors, if they gain political power, back the decisions favourable to the Russian government or Gazprom (Makaraityte 2010).

70 According to an opinion poll carried out for the European Commission in 2005, 47% of the respondents from all 27 EU member states support that decisions on key energy policy issues are taken at the European level, whereas 37% favoured decisions at the national and 8% at the local level (European Commission 2005).

71 Petra Opitz, for instance, states that if there is the possibility to import electricity or gas from Belarus for the lowest price, this should be done. If Belarus or Russia are considered not to be fully reliable suppliers, then the Baltic States should make their domestic market attractive for investors who would be interested in building the electricity/gas grids/pipelines and profit from the energy resources import from Finland, Poland and other countries. A new NPP could be constructed if the Baltic States plan to build up an export strategy – this could be also interesting for investors. A decision on the construction of an LNG terminal should be built on the same logic – first of all it should be evaluated whether the market is big enough to sell the imported gas. Dr. Petra Opitz, Manager at DIW econ, interview by author, 18 December 2009, Berlin, Germany.

Thus, despite repeated advice to concentrate on national efforts, the Baltic States hope instead to extend the reach of this very important area of ‘common’ EU policy. Two conceptual directions of their strategy – establishing a common EU perception on ‘solidarity’ in energy affairs and application of the real ‘reciprocity’ principle within EU-Russia energy relations – were analysed in the third chapter. It was stressed that disputes related to ‘consumer solidarity’ arise first of all due to differences in the various national discourses and divergent views on how to implement this principle, but not because member states oppose the ‘solidarity’ idea as such. Nevertheless, it was concluded that the implementation of the principle of ‘consumer solidarity’, as it is understood by the Baltics, is of prime importance for the Baltic States if they hope to finance nationally or regionally important energy infrastructure development projects from the EU budget.

As regards the debate on reciprocity, the *status quo* of EU-Russia energy relations according to the Baltic States can not be considered as strategic, predictable and equally beneficial for both parties in the partnership. The Baltic States argue that it represents asymmetrical producer-consumer relations that neither boost the aspired modernisation and transformation of Russia nor oblige Russia to fulfil its commitments to supply Europe with the promised amount of gas. Therefore it would be in the interest of the EU to conclude a long term agreement on energy issues with Russia. However, the revival of, for instance, negotiations on the ECT is hardly possible, as Moscow perceives the ECT to be ‘not balanced’ and countervailing to Russian interests. The goal of the Baltic States in this regard is not to roll back Russian investment decisions, but to agree on some stricter terms of how the gas price is established, under which conditions Gazprom may invest, etc. In this context, this paper has argued that the main task for the Baltic States is to equate the attitude that the EU holds towards Gazprom’s monopolistic position with the attitude it holds towards, for instance, Microsoft and its monopoly in the IT sector.

The following policy recommendations (addressing the Baltic States’ governments) can

be deduced from the analysis. First, in contrast to the cases of Western and Southern Europe, the EU has never had a debate regarding the interconnections with the Baltic States. Thus, soon after the EU begins investment in Nabucco, which is aimed to supply both Central and South Eastern Europe, or to deliberate the Caspian Development Cooperation, the Baltic States should point out the imbalance created by the focus on these projects and propose measures that will similarly benefit *their* situation of supply security.

Second, the Baltic States should base their motivation on reasons of *market structure* and present the desired energy infrastructure development projects as enabling a competitive market structure. In other words, they should explain to their partners that the current market structure is such that some states experience a monopoly risk. Therefore new pipelines, LNG terminals or NPPs are needed not to get somebody out of the market, but are instead vital to keep prices within certain limits and avoid political influence. In this regard, the Baltic States could argue that even if the LNG terminal or gas interconnections options will be difficult to commercialise, this will not necessarily mean that someone is losing money. Rather, these assets will serve to definitively limit monopolists’ prices and thus benefit consumers. Indeed, this difference in prices may even make some non-viable projects viable.

Third, in the spirit of solidarity the Baltic States should insist on a combination of two aspects: (a) physical energy interconnections and investments and (b) policies promoting competition and restricting market monopoly powers. This way, they could back the development of the external energy policy dimension and at the same time call for the application of competition and market rules.

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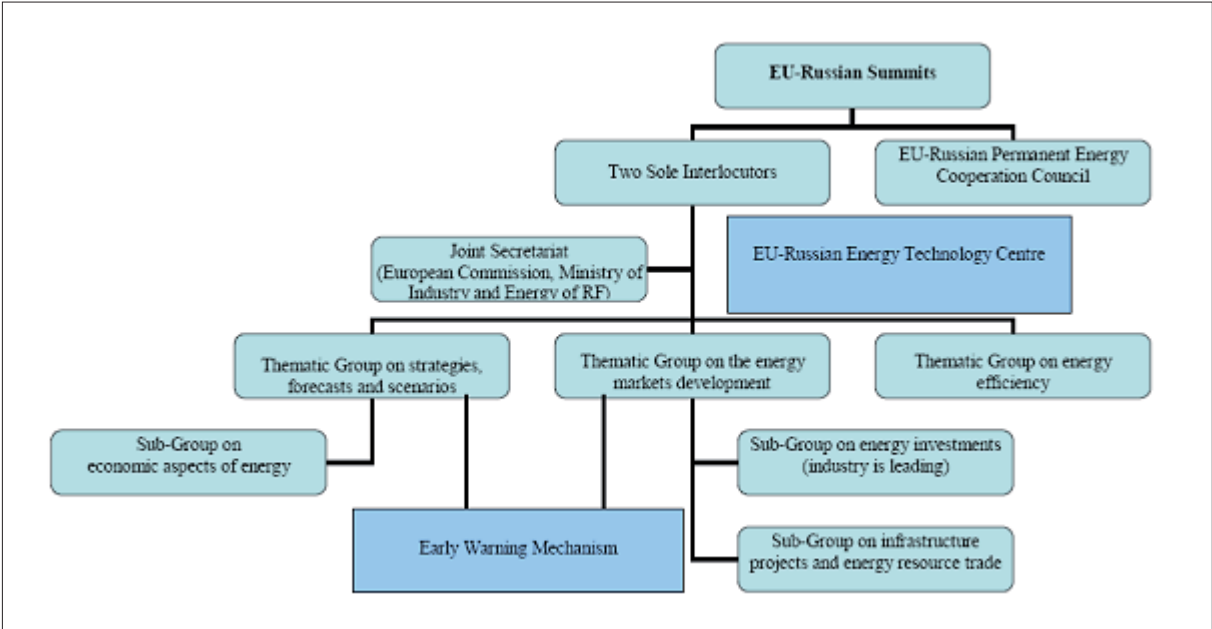
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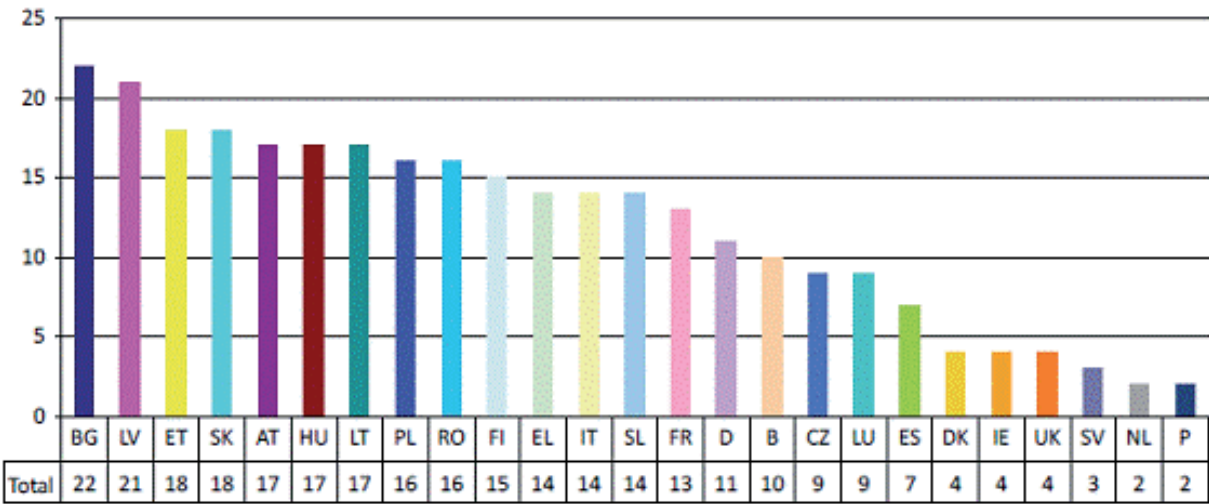
Annexe

Figure 1. Institutional structure of the EU-Russian Energy Dialogue



Source: Romanova 2009.

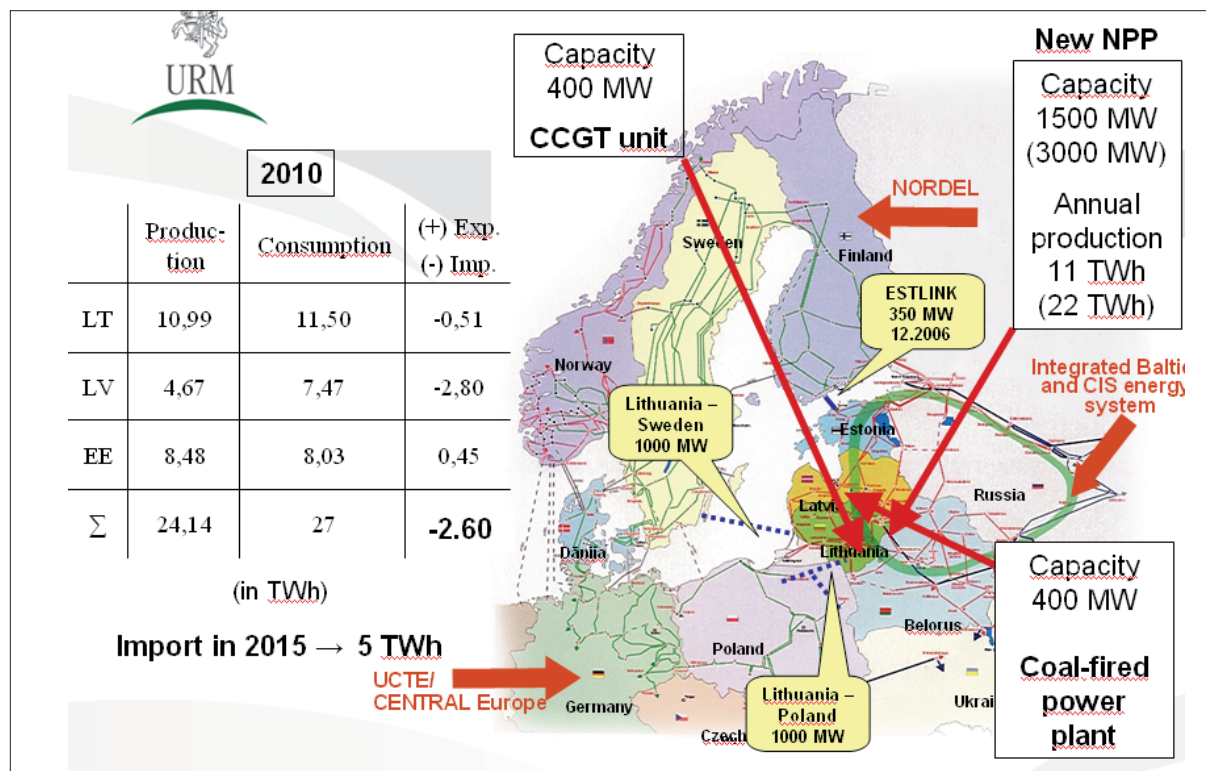
Figure 2. Index of national vulnerability to “Gazprom Supply Cuts”



Source: Dreyer/Erixon/Winkler 2010.



Figure 3. Electricity import-export capacities of the Baltic States



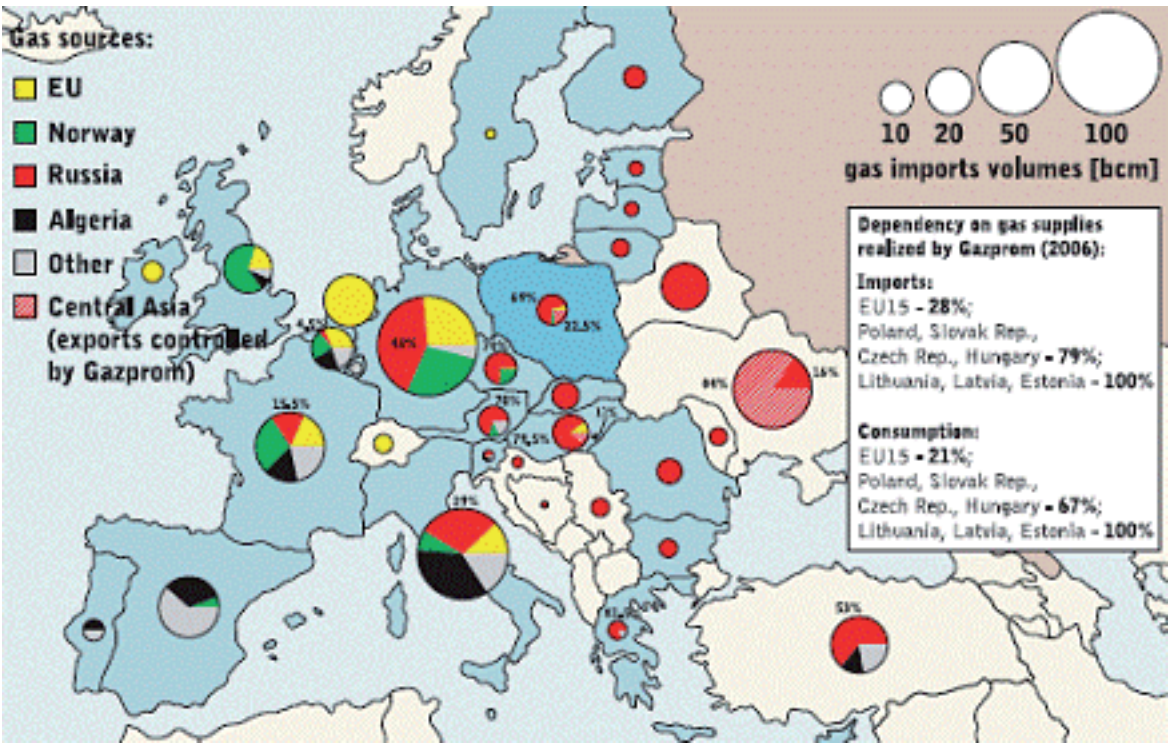
Source: Naudužas 2009.

Figure 4. Gas pipelines in the Baltic States



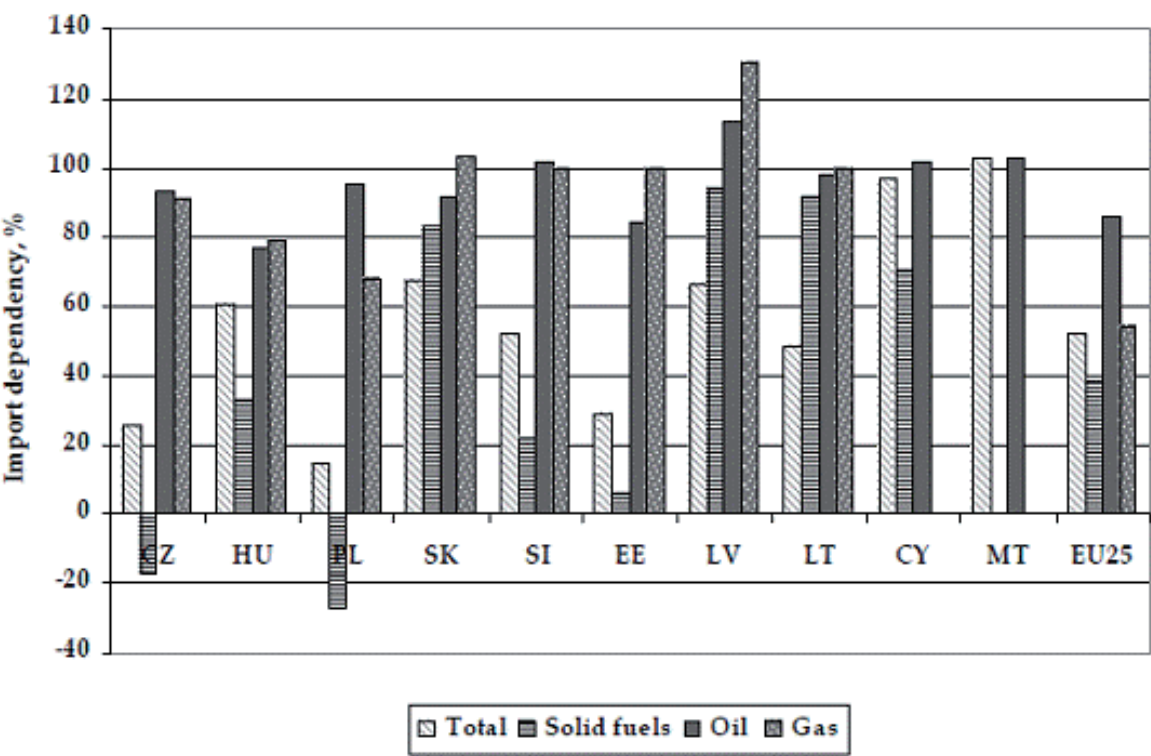
Source: Veiderma 2005.

Figure 5. European dependence on Russian gas



Source: Loskot-Strachota 2008.

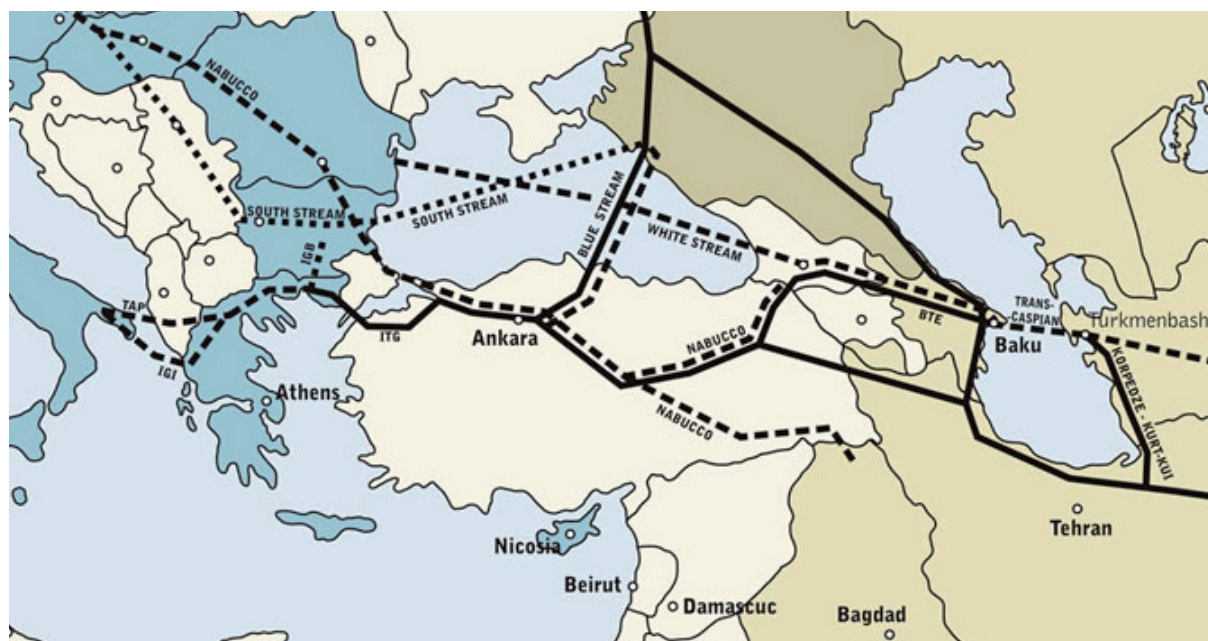
Figure 6. Net imports / total consumption in the new EU member states



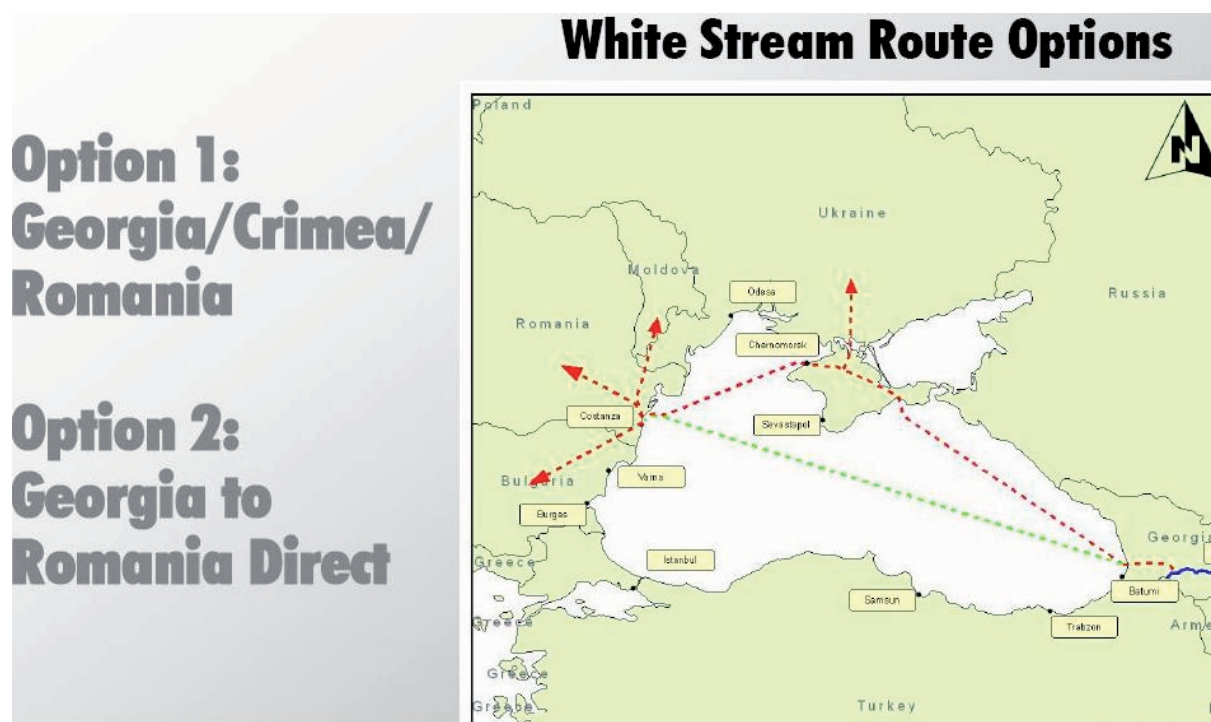
Source: Kaderjak 2007.



Figures 7. Gas pipelines to Europe

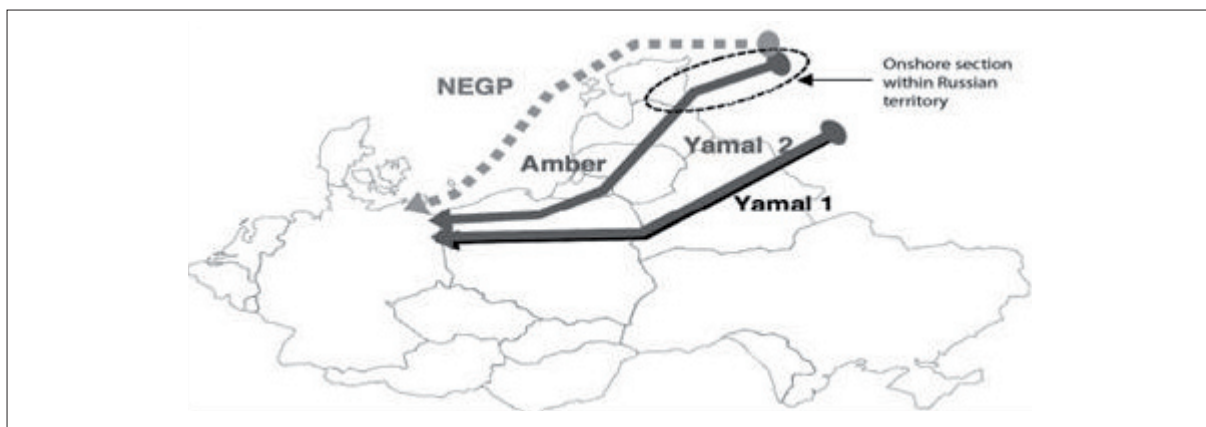


Source: Jarosiewicz 2011.



Source: Vashakmadze 2007.

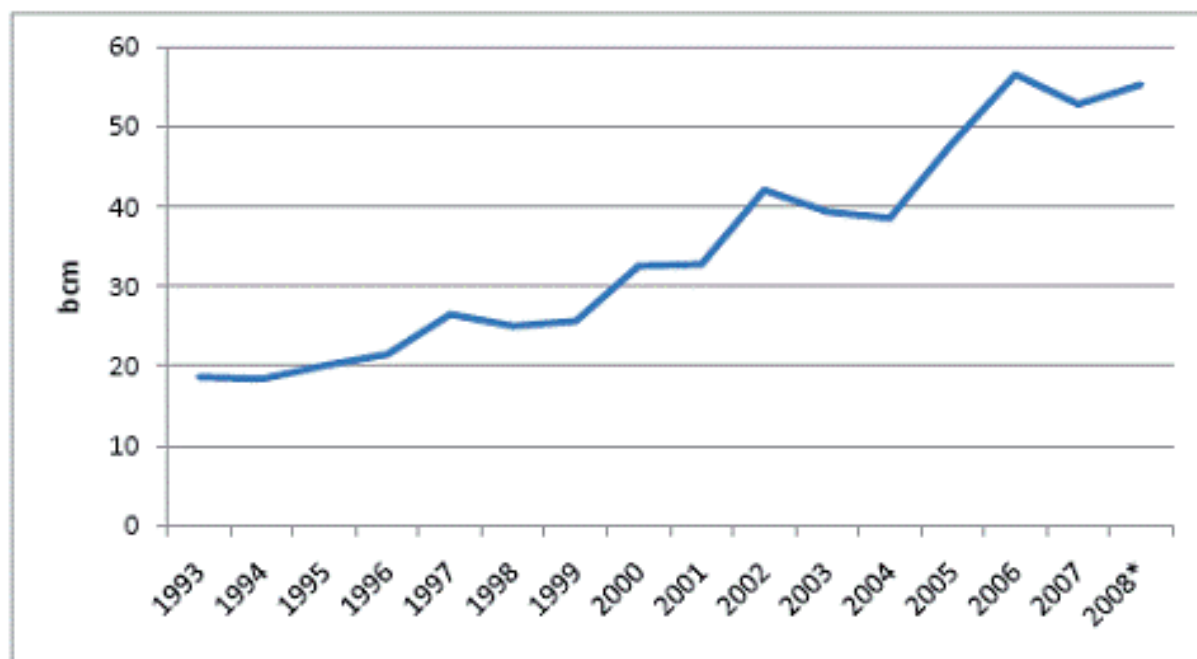




Source: Liuhto 2009.

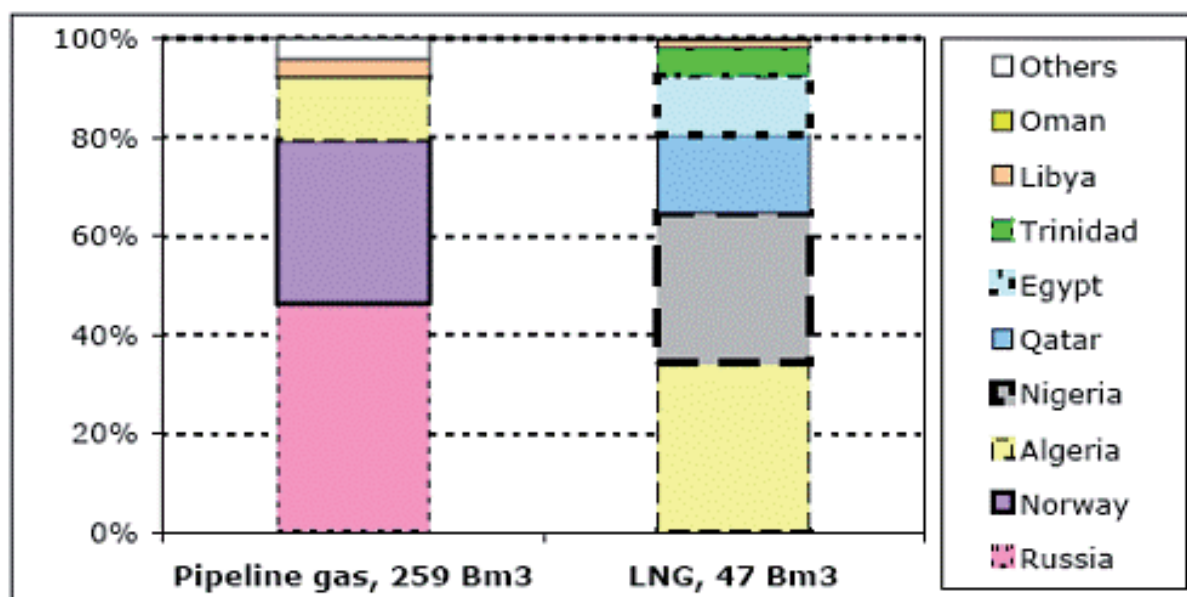
**Figures 8: LNG import and consumption in Europe**

*LNG imports to Europe*



Source: Energy Policy Research Foundation 2009.

*Pipeline and LNG net imports in the EU by countries of origin (in 2007, %)*



Source: Kavalov/Hrvoje/Aliki 2009.

Chart 1. Most important energy infrastructure projects for the Baltic States

PROJECT	CAPACITY	ESTIMATED CONSTRUCTION COSTS	OWNERSHIP	OPERATIONAL SINCE	STATUS	MAIN CHALLENGES
ESTLINK	350 MW	110 million €	Eesti Energia (39.9%) Latvenergo, Lietuvos Energija (25% each), Pohjolan Voima, Helsingin Energia (remaining 10.1% each)	2007	Operational	Too low capacity of the first cable
	Second cable – 635 MW	Second cable – 250 million €		Second cable - 2013	Second cable under discussion	No funding for the second cable
NORDBALT (SWEDLIT)	700 - 1000 MW	516-738 million €	Lietuvos energija, Svenska Kraftnat, Augstsprieguma Tīkls (final parties to be clarified)	2016-2017	Construction begins in 2010	The reinforcement of domestic power grids in Lithuania; No energy surplus in Sweden;
LITPOLINK	1000 MW	237 million €	PSE Operator, Lietuvos Energija	2012-2015	Under discussion	The reinforcement of domestic power grids in Poland and Lithuania is needed
New NPP	In LT	3-5 billion €	Lietuvos energija, Latvenergo, Eesti Energia and Polska Grupa Energetyczna	2018-2019	Under discussion	Funding, other planned nuclear power plants in the region
	In EE	Not calculated	Eesti Energia	2025	Under discussion	No necessary legislative, experience, funding.
	In KD	6 billion €	Rosatom, 49% of shares in the project will be offered to European companies	First reactor 2016, second - 2018	Under construction	Funding

PROJECT	CAPACITY	ESTIMATED CONSTRUCTION COSTS	OWNERSHIP	OPERATIONAL SINCE	STATUS	MAIN CHALLENGES
Underground gas storage	In LT	Syderiai 0.5 bcm	347million €	No decision	2015	Funding
	In LV	1. Expansion of Incukalna storage to 3,2 bcm 2. New storage in Dobele: 6 bcm	140 million € (plus 250-350 million € for cushion gas) 230million €	Latvijas Gaze Not decided	Operational Feasibility study 2009-2010	
LNG terminal	In LT	3.5-5.3 billion m <sup>3</sup> /year	270-320 million €	Contributors are unclear	2012-2018	Transparency, funding, role of GAZPROM in the region
	In LV				2012-2018	Funding, role of GAZPROM in the region
	In EE	2.5 billion m <sup>3</sup> /year	480 million €	Eesti Gaas, Others	2015	Funding, role of GAZPROM in the region
Southern Corridor	Nabucco	25-30 billion m <sup>3</sup> /year	7.9 billion €	OMV, MOL, Transgaz, Bulgargaz, BOTAS, RWE	2014-2015	Lack of gas
	White Stream	32 billion m <sup>3</sup> /year	2.5 - 3.5 billion \$	Not disclosed	Stage 1 in 2016	Lack of gas
	Trans-Caspian pipeline	30 billion m <sup>3</sup> /year	2,5 billion \$	PSG International, Shell	Feasibility study in 2010	Russian-Iranian objections; Disagreements between Turkmenistan and Azerbaijan

PROJECT	CAPACITY	ESTIMATED CONSTRUCTION COSTS	OWNERSHIP	OPERATIONAL SINCE	STATUS	MAIN CHALLENGES
<b>Nord Stream</b>	55 billion m <sup>3</sup> /year	7.4 billion €	Gazprom, BASF/Wintershall, E.ON Ruhrgas, Gasunie	2 Lines. First scheduled for 2011, second for 2012	Preparations for the pipeline's construction	Environmental danger; Russia's instrument of political pressure
<b>South Stream</b>	63 billion m <sup>3</sup> /year	19-24 billion €	Gazprom, ENI,	2015	The construction is to start in 2010	Rival to the planned Nabucco pipeline
<b>Odessa-Brody-Plotsk-Gdansk oil pipeline</b>	15-40 million t.	360 mln. - 3,5 mlrd. \$	UkrTransNafta, PERN, SOCAR, GOGC, Klaipedos Nafta	2004	"reverse-use" of the pipeline	Lack of funding and oil, political disputes between Russia and EU
<b>Baltic Pipeline system 2 (oil)</b>	50 million tons/years	4 billion \$	Transneft	2012	The construction started in 2009	

Own compilation based on the following sources: *Nordic Energy Link 2008, InterLinks 2008, Lietuvos elektros organizacija 2007, Paškevičius 2008, World Nuclear Association 2009, Tubalkain-Trell 2009, Kuprys/Kugelevičius 2008, High Level Group 2009.*